United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL 74-1694

To be argued by
LAWRENCE M. POWERS

United States Court of Appeals
FOR THE SECOND CIRCUIT

TITAN GROUP, INC.,

Plaintiff-Appellant,

against

HAROLD FAGGEN,

Defendant-Appellee.

BRIEF FOR APPELLANT

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This appeal is from a $6,454,055 judgment of damages after trial (non-jury) by the District Court, rendered April 22, 1974. The Court dictated its findings of fact and conclusions of law onto the record at the conclusion of counsels' summation on March 19, 1974; this transcript excerpt constitutes the opinion below on the issue of liability.[1] A motion with respect to damage computations resulted in a subsequent memorandum, followed by a hearing and supplemental judgment on attorneys' fees included in the award appealed from (58a).

Plaintiff Titan Group, Inc. ("Titan") is a publicly held corporation with over 8,000 shareholders, primarily engaged in the construction business. Its stock is traded over-the-counter, and at the time of the events herein, late 1968, it was heavily committed to the ownership of real estate—apartments, hotels and motels. Titan's entry into the actuarial consulting field through the acquisition of four related corporations (the "Faggen Companies") owned by defendant Harold Faggen ("Faggen") is the subject matter of this action. The Faggen Companies, engaged in providing actuarial consulting services to union pension and welfare plans, were acquired by Titan on December 2, 1968, when all of the outstanding stock of these four corporations was exchanged for Titan's securities. Titan claims that the contract was induced by fraud, in violation of Rule 10b-5[2] under the Securities Exchange Act of 1934 and the common law. Titan gave $5,500,000 face amount of 4% convertible installment Notes (the "Notes"), and after paying interest to Faggen from 1969 through 1971, Titan determined it had been deceived in the written representations by Faggen which led up to the exchange of securities. On May 2, 1972 Titan brought this action seeking to cancel the Notes for fraud and refused to make any further interest payments pending a determination in this action. Faggen treated the refusal to pay the May 1, 1972 semi-annual installment of interest ($110,000) as a default, and counterclaimed to accelerate payment of

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[1] Joint Appendix ("6a"); after 70a, new numbering starts with Appendix page references by number alone.

[2] (17 C.F.R. § 240.10b-5).

the entire face amount of the Notes. After eighteen months of pre-trial discovery and motions, including Mr. Faggen's motions to compel interim interest payments, which were denied below with such denial affirmed on appeal,[1] trial was commenced, concluding in March, 1974, before the Court. The Court determined that Titan had not proven that Faggen had violated Rule 10b-5 or the common law in connection with his written representations to induce the subject contract, dismissed Titan's claim, and entered judgment for the entire amount of the counterclaim to enforce the Notes held by Faggen. This appeal followed.

There are two issues on this appeal. First is the determination of the proper principles of law to be applied on the issue of liability of Faggen to Titan under Rule 10b-5. Second, should the decision on liability be upheld, is the issue of the proper measure of damages to be applied to Faggen's counterclaim for full payment on Titan's notes.

The securities transaction is bracketed by a well-defined timetable of meetings, written presentations and discussions, between May, 1968 and December 2, 1968. In the Spring of 1968, Faggen decided he was interested in merging his actuarial consulting business into a larger organization, in exchange for stock. He began discussions with two other potential acquirors, Levin-Townsend Corp. and Diebold, Inc. He also visited with a lawyer friend, Benjamin Robinson, to discuss whether Titan would be interested in acquiring the Faggen Companies (24, 27, 30-31). Robinson, although heading a New York law firm and specializing himself in union pension and welfare plan counselling, was then Chairman of the Board of Titan. Robinson was interested in acquisitions other than in real estate, where Titan was then concentrated, because a new group, headed by one Gerald Block, based in Los Angeles, California, had just taken a controlling voice in management. Titan was the successor corporation to the old Futterman Corp., a real estate management cor-

[1] See Appeal #73-1345, affirming the denial of interest payments and sending the case back for trial in early 1974. References to that Appendix, previously on file, are "—A #73-1345".

poration that had gone public in the early 1960's. After the death of its founder, Robinson as lawyer for the estate, had by 1968 become the dominant figure on its Board. A large bloc of stock from the Futterman estate was sold to the new control group in Los Angeles in 1968, and they wished to diversify the operations of Titan. When the Faggen negotiations commenced, the new group had designated a president-director, Anthony Frank, and were feeling their way slowly into the control position that Robinson had presumably sold them. The Faggen Companies were the first acquisition undertaken by this new management group in Titan (103-109).

Robinson met with Faggen over the summer of 1968, and introduced him to President Frank for several meetings. In August, 1968, Robinson indicated that he had gotten Harold Faggen to the point where "he was ready to take the steps and write up his company and tell its earnings" to Titan's management (330, 268A # 73-1345). At that point, Edmund M. Kaufman, a Los Angeles lawyer specializing in acquisitions, was brought in as representative of the Block control group to handle the financial negotiations with Faggen. Their first meeting was held September 6, 1968 in Robinson's law offices. Faggen was at that time in negotiations with Diebold, Inc. to acquire his companies, and he informed Kaufman of this (116). Faggen explained that his privately owned business was earning substantially more than its taxable income reflected. Faggen handed to Kaufman a June 30, 1968 income tax return of his main corporation (Harold Faggen Associates, Inc.) showing $288,000 in pre-tax income, together with a handwritten (by Faggen) memorandum of pro-forma adjustments which increased such 1968 income from $288,000 up to $571,000 for all four corporations. The handwritten adjustments presented by Faggen (Ex. 1, 1342, 1355, the "Diebold memo") added (a) the income of his three minor corporations and (b) several positive accrual type and other adjustments to earnings which did not show on the income tax returns for each of the four Faggen Companies to reach $571,000 pre-tax earnings. The Diebold memo

also deducted some $50,000 in investment income from securities transactions from its schedule of adjustments.

Faggen had been using this pro-forma memorandum in his negotiations with Diebold, Inc. and told Kaufman he wanted to be paid ten times his pre-tax earnings as adjusted, plus his net worth ($1.6 million) for the Faggen Companies—to be paid in Titan shares (116-117). The face amount under discussion was $7-7.5 million payable in market value of Titan shares. Kaufman's contemporaneous notes on the pricing discussion, also include several factual matters describing the actuarial business, number of employees, clients, future plans, etc. of the Faggen Companies (1377, 124-128). Faggen, a law graduate and a certified public accountant, was an impressive proponent for his actuarial business. Kaufman made another appointment to negotiate further, asking to see the tax returns for Faggen's other three minor companies which had been incorporated in the pro-forma series of adjustments.

The next meeting occurred October 2, 1968, in Faggen's New York offices (131). Kaufman looked over the tax returns which were the basis for the upward adjustments, and negotiated with Faggen on price. Kaufman was informed that besides earning in excess of $550,000 pre-tax in 1968, the adjusted earnings were approximately $500,000 during the preceding years (143-144). Kaufman indicated that Titan would pay ten times earnings on the $550,000 in 1968 adjusted earning power presented by Faggen, but would not pay separately for net worth, on the theory that paying this high growth multiple (20 times after-tax earnings) required the receipt of some hard value as part of the package (134). Kaufman then offered $5.5 million in convertible installment notes in lieu of stock,[1] with an average conversion price slightly above Titan's then market price of $16 per share. The parties shook hands, and Kaufman, at Faggen's insistence, agreed that interest would be payable as of that date, October 2,

[1] Convertible securities were offered because of the new control group's unexpressed fear of issuing a large bloc of Titan stock right after they had bought control (110).

1968, even though the paper work would take several weeks to complete (42). Kaufman reported the agreement to Chairman Robinson and President Frank, and went back to Los Angeles to draw the first rough draft of the formal contract and send it to Robinson's law firm (general counsel of Titan) to complete and close (139). Kaufman was largely out of the negotiations and closing steps after October 2, except for telephonic clearances on minor matters handled by Robinson and his law firm or by President Frank in New York City (145).

On leaving the key negotiating session with Faggen, Kaufman asked him to take the crucial step upon which this case is based. Kaufman asked Faggen to write up his pro-forma earnings for four years as orally discussed with him, and to write up a description of his business and clientele, for the records of Titan and submission of the transaction for Board approval (43, 140-141). Faggen then wrote up this memorandum in longhand (Ex. 2A-3, the "selling memo", 1362-1372), with two exhibits—a four year pro-forma statement of earnings showing $571,000 pre-tax for 1968 and nearly $500,000 for two preceding years, and a list of new clients each year for such four year period, with total numbers of clients. The selling memo was taken on or about October 7, 1968 to Chairman Robinson, and was typed up at Robinson's law office (46, 332-334). Frank and Robinson reviewed the memo, discussed it with Faggen, wrote some key notations thereon (i.e., "excludes investment income") and it became the basis for Frank presenting the deal to Titan's Board of Directors on October 9, 1968 (276-277).

The Board minutes approving the deal tracked some of the descriptive material in Faggen's memorandum describing his business (285, 191-192A, #73-1345). Seven members of the ten man Titan Board (which included Robinson and Frank) were present at the meeting. Six of the seven were called as witnesses by Titan, and all six (quoted *infra*) remembered the oral presentation by Frank, and his describing the impressive earnings figures. Faggen was then welcomed into the Titan organization, socializing with the board right after their meeting (47).

This October 7, 1968 selling memo by Faggen was a merchandising tool, employing pro-forma adjustments to income of the same general type as that used in the set of adjustments for 1968 presented to Kaufman in the Diebold memo at the first negotiating session four weeks earlier. But there was one huge difference—the types of adjustments Faggen had in mind were listed in detail on the Diebold memo, but several different adjustments, undisclosed, were used to reacch the same $571,000 in earnings in the memorandum for Titan's Board. The claimed omissions in this selling memo fall into three categories.

1. The adjustments for a privately held business used even in the Diebold memo were highly questionable, if not being outright invalid in large part. Faggen himself rejected most of these adjustments at trial, saying he did not accept them, but wrote them down in a spirit of cooperation with the Diebold negotiator (one Rogov), trying to put the best appearance on Faggen's earnings for a future public offering (80-82, 71-76). But as to the October 7 selling memo there were no detailed disclosures of these adjustments underlying the four year presentation of adjusted income, 1965-1968, which went to Titan's executives and directors (1371). Differences between what had been given negotiator Kaufman in the Diebold memo and in the selling memo, were not disclosed, although substantial. But in any event, neither set of adjustments which built up 1968 earnings from a base of $350,000 to $571,000 were valid, and the whole portrayal was exaggerated in scale and in the four-year trend of earnings in the Faggen Companies. As will be seen, (a) investment income was included in the selling memo without separate disclosure, when it had been expressly deducted in the Diebold memo, (b) assumed pension fund savings were added to income without foundation or adequate disclosure, (c) salary savings and (d) expense account savings were added on to income on non-existent, or undisclosed questionable, grounds, and (e) negative adjustments to income were ignored. The result was a gross overstatement of adjusted earnings for all four years.

2. The selling memo was further deficient in required disclosures in that it listed in an "Analysis of Clients" a year by year presentation of new actuarial clients obtained by the Faggen Companies. But Faggen's presentation omitted to disclose the loss of a large number of important clients, particularly in 1968, the year of acquisition, and other material aspects of client relationships. The lost clients represented 10% of 1968 gross revenues of the Faggen Companies, had a foreseeable 20% adverse trend on future earnings, and included its single biggest account plus several other significant clients.[1]

3. The third area of omissions in the selling memo was the delineation of capability in the computer service field and a computer service program well into development, and in discussion with important new clients, which was imaginary. In fact, the four Faggen Companies had only two low level employees who knew anything about computer programming, had no automated computer program at all for pension and welfare plan administration, and had no contracts in being with anyone, or even any negotiations in progress, with the claimed stockbrokers, accountants or lawyers as intended customers for packaged pension plan services, described in the selling memo. The description of pension plan computer capability omitted to disclose the elementary start-up level of the business plans.[1]

The final omissions to disclose which underlie plaintiff's claims are outside the four corners of the misleading selling memo. These omissions revolve around the pivotal role of Chairman Robinson in recommending the Faggen acquisition to Titan, and vouching for the integrity and competence of Faggen as an accountant and actuarial consultant. Neither Faggen nor Ben Robinson fully disclosed their intricate web of professional and business relationships detailed, *infra,* including a personal lawyer-client relationship going back years, substantial fees through client referrals recently conferred on Robinson by Faggen, and partnership ventures in real estate, with Faggen in-

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[1] **References to the transcript are detailed *infra* on these points.**

vited to join Robinson's law partners therein (355-359, 440). Robinson's independence was compromised, and their relationship made Robinson endorse Faggen's statements and writings completely, but would have made executives and directors alerted to the entire situation between them require an audit of the four years, as adjusted, which was never undertaken in this transaction. The claim on this point is, in essence, that Faggen had a measure of control over Robinson's judgment, and didn't disclose it to Titan. Robinson's law firm handled all aspects of this transaction from October 2, 1968 onward, using Kaufman's draft contract but making all the basic legal decisions in New York and using Robinson himself to moderate on "sticky" contractual points (349-351). The 26 year old associate lawyer (witness Rosen) in Robinson's firm who handled the $5.5 million transaction (418) never saw the crucial selling memo that went to Robinson and other executives, and was summarized to the Board (423-426). Robinson's legal associate knew nothing of the underlying business representations that made the deal (432-435, 429). The final acquisition contract was based merely on a set of cash basis tax returns and other representations substantially attenuated from the business facts which induced the $5.5 million handshake—the deal was sold one way, and put in writing on a far different basis.

The relationship between Robinson and Faggen fostered a harmonious drafting job and a prompt closing, with Titan's accountants making a review only of Faggen's balance sheet items (451, 457-458). Chief accountant McIntyre, after oral inquiry of Faggen on what earnings adjustment items he had in mind for 1968 alone accepted Faggen's explanations; accountant Russo assigned to check on the balance sheet was clear that this was "Ben Robinson's deal" and was under instructions to accept the unaudited financial statements based solely on tax returns (466, 1433-1435). Faggen presented strong reasons for not permitting Titan's outside auditors into his books, claiming they had a competitive actuarial operation (474, 1459). No attempt was made to audit the adjustments which created the $571,000 in pre-tax earnings and in turn created

$5.5 million in Notes at a ten times multiple (463). To this day, Faggen has never presented the work sheets he used for all four years of pro-forma adjustments, claiming they were all in his head or on adding machine tapes, presumably thrown away (83-84). Changes in management in Titan after 1968 kept these crucial facts of undisclosed conflicts of interest from coming to light until 1972. During such period (when Titan suffered problems in many other divisions), the only Titan directors with any continuity are Robinson and Faggen (880-881, 886-887). Titan's new management in mid 1971 began to question how $5.5 million in Notes were paid for a company that was not earning enough even to pay the interest thereon. After months of investigation, obstructed by Robinson and Faggen at every turn, the selling memo and the Diebold memo surfaced, to be measured by the first audit of actual earnings during the 1965-1968 period (289-296A #73-1345, 913-921). The results showed that the transaction was induced by deception, and this action followed.

Questions Presented

1. Are omissions to fully disclose questionable accounting adjustments which increase income by 63% in a pro-forma statement of income, material non-disclosures under Rule 10b-5 and the common law? The Court below answered this issue in the negative.

2. Are omissions to disclose the recent loss of 10% of the clientele, and a foreseeable drop of 20% in earnings, of a personal service business material nondisclosures under the securities laws? The Court below thought not.[1]

3. In an exchange of securities where the principal claim is omission to disclose material facts, is proof of reliance necessary to plaintiff's case under Rule 10b-5? The Court below answered that proof of reliance was necessary.

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[1] We need not state the similar questions presented on materiality of a described, but imaginary, computer program, or on an undisclosed web of joint interests with Titan's principal proponent of the transaction, Chairman Robinson (discussed *infra*).

4. Is proof that all of Titan's negotiators and six directors out of seven at a Board meeting specifically recalled the magnitude of the earnings presented, the ten times earnings price formula and voted unanimously for the acquisition, adequate proof that they relied on such earnings? The Court below thought not.

5. On the damage issue—if no fraud is found, and defendant is entitled to enforce his acquisition securities, is it a penalty to award $5.5 million in cash for low-grade (4% subordinated) installment notes, with seven more years to run, when these notes were worth only $3.2 million when issued and even less when the claim arose? The Court below concluded that the $2.3 increment resulting from acceleration was not a penalty and awarded it.

POINT I

Plaintiff Proved That It Was Defrauded By Defendant As A Matter Of Law.

The linchpin of the District Court's decision is its determination that "Titan by its officers and directors did not rely substantially upon any of the information which plaintiff now claims that it did" and "There are a variety of reasons why I think reliance or the lack thereof is the key to this case" (31a). On materiality, the District Court said "I have considerable difficulty in finding . . . that Faggen made knowingly false material statements or purposely withheld material information which was necessary to make the picture complete in his negotiations with Titan Group" (26a). Titan's propositions of law on these two points and a summary of its argument are:

In a case primarily of material omissions, there is no necessity to prove reliance upon the facts undisclosed. *Affiliated Ute Citizens* v. *U.S.*, 406 U.S. 89 (1972) and *Shapiro* v. *Merrill, Lynch, etc.*, —— F. 2d —— (2d Cir. April 3, 1974), CCH Fed.Sec.L.Rep. Par. 94,473. The District Court applied a principle of law no longer, if ever, in effect in non-disclosure cases.

Moreover, plaintiff has, in any event, established reliance as a matter of law by overwhelming proof de-

tailed below. On the issue of whether a written document contains material omissions of fact, or was relied upon, the Court of Appeals can search the record and make its own determination of materiality and reliance, i.e. deception, by applying the ruling principles of law to the established events. "In answering this question [was the financial statement misleading] we must, of course, give full weight to the district court's findings of fact, even while we are free to look to the application of the securities law to the facts found." *Republic Technology Fund, Inc.* v. *The Lionel Corp.*, 483 F. 2d 54[illegible] 45 (2d Cir. 1973) and see *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341, 364 (2d Cir. 1973); "Our disagreement with the district court on whether defendants have violated [the proxy rules] . . . does not go to its findings of fact, as to which the 'unless clearly erroneous' test applies, but to its application of the legal standards just discussed," reversing a District Court ruling of no material omissions and no reliance. From this analytical perspective, we turn to what is largely a documentary review.

A. The Written Representations Used to Induce the Contract Contained Several Material Omissions of Fact.

1. *The Non Disclosure of Special Accounting Adjustments Used to Create Earnings.* This case presents the situation of a sophisticated seller, actively engaged in the practice of accounting, telling a corporate buyer that a privately held business is earning substantially more than its cash basis tax returns indicate. It is a common occurrence when public companies acquire privately owned companies. The concept here was that the Faggen Companies were not earning just what was shown on their tax returns, but substantially more under generally accepted accounting principles, and the concept was conveyed with two precise memos by Faggen, the Diebold memo and the selling memo. Essentially, $350,000 in reported taxable income was adjusted upward by $221,000 (a 63% increase) to reach the $571,000 for 1968 shown in these memos. Adjusted income figures for three preceding years were also presented with the same logic. This starting point

from the tax returns is not in dispute—the 1968 pre-tax income of the four Faggen corporations (excluding investment income) is $315,008 and to this is added $35,280 in fees from his accounting practice to give $350,000 in pre-tax income from his combined operations.[1] The validity of his walk up this ladder to $571,000 is the first subject for examination on this appeal. What rules of legal analysis apply to such method of selling a business? We submit they are no different than in any other securities transaction. The adjustments, both positive and negative, must be fully disclosed, they must be valid, and where there is any doubt, there should be sufficient disclosure to enable the buyer to evaluate the adjustment for himself. "The securities laws impose . . . a duty to act reasonably . . . disclosing fully those material facts of which the offeree is presumably unaware and which ostensibly would influence his judgment." *Chris-Craft Industries* v. *Piper Aircraft Corp., supra,* at p. 369. Faggen presented his adjusted earnings as follows in the selling memo (1366):

"Net Income—Pre-Tax
Adjusted to basis which will
prevail after acquisition

	Fiscal Years Ending In:			
	1965	*1966*	*1967*	*1968*
Harold Faggen Associates, Inc. (June 30)	$253,357	$367,087	$332,192	$430,596
Actuarial Tabulating Corp. (March 31)	59,878	60,976	59,201	65,806
Employee Fund Services Corp. (Sept. 30)	32,767	27,891	25,252	29,104
Harold Faggen, Personal (Dec. 31)	34,800	34,800	35,240	35,280
Totals	$380,802	$490,754	$451,885	$571,262"

Faggen's summary earnings presentation, while careful to note the minor technicality of different fiscal year closings for each corporation, omits to disclose more fundamental

[1] H. Faggen Associates, Inc. $254,703, Act. Tab. Corp. $29,289, Empl. Fund Serv. $20,600 and Fund S&E $10,416 total $315,008 plus personal accounting fees of $35,280 in 1968 (see Ex. 10, 1385-1388, 1968 Column, 564). Investment income totaling $51,777 has been deducted for separate discussion *infra.*

items, which make up the swing in 1968 from $350,000 in tax return income to $571,000, a buildup of $221,000. The elements are:

a. *Undisclosed Investment Income.* (i) First, there is no identification on the selling memo that, as Faggen now contends, the totals include substantial capital gains, interest and dividends from Faggen's stock market operations. The typed version (typed in Robinson's office) and its handwritten predecessor (1366, 1371) make no distinction between operating income and investment income—these extraordinary items represented as part of the total earnings $51,777 in 1968, $30,522 in 1967, $78,582 in 1966 and $36,377 in 1965 (Ex. 10, 1384)—roughly 10% of the claimed total earnings in 1968, the year of acquisition, and from 8% to 18% in the other years. These are plainly material amounts, particularly after other exaggerations in the earnings (discussed *infra*) are squeezed out, which make investment income a higher percentage of the actual amounts each year.[1] Faggen said at trial that he reached the adjusted total of $571,000 in 1968 and the totals in the other three years in Ex. 3 by *including* investment income (988, 378A, 473A, #73-1345). But generally accepted accounting principles required the Faggen Companies to distinguish between operating income and investment income in presenting a summary of income. To leave out a disclosure that a material part of the income was from stock market activities was, as a matter of law, to mislead the reader. See S.E.C. Acctng. Rules, basic rules on "Income Statements," CCH Fed.Sec. L.Rep. Par. 68,596-68,597, requiring separate treatment of "Other Income" from income derived from "sales of tangible products." "Other Income" (CCH Par. 68,597) lists "7. Dividends . . . 8. Interest on Securities . . . 9. Profits on Securities . . . 10. Miscellaneous Other Income." It was held misleading to show income of an unusual and nonrecurring type as "other income" without

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[1] On audited income of $404,000 in 1968, investment income is 13% and is up to 25% of the actual income totals 1965-1967. See *infra*, p. 21.

any explanation of the nature of the income and the accounting practice followed, *Matter of American Terminals and Transit Co.* (1936) 1 S.E.C. 701. See Rappaport on *S.E.C. Acctng. Practice and Procedure* (3rd Ed.), p. 18:27-28 on separate treatment of investment type income from operating income, or p. 16:14 quoting *S.E.C. Acctng. Series Ruling* ("ASR") #41 ". . . in the corporate income statement of a company having large investments . . . in the securities of unaffiliated companies, the disclosure of income from dividends and interest is necessary irrespective of the amount, since the absence or smallness of dividend and interest income is of as great importance as the exact amount thereof." Rappaport mentions at 2:1-2, that the S.E.C. "may prescribe the methods to be followed . . . in the differentiation of investment and operating income . . .," showing the distinction is a fundamental disclosure principle, and see Accounting Principles Board ("A.P.B.") Statement No. 4, par. 198 which accords with the S.E.C. rule: "R-8D *Extraordinary items.* Extraordinary gains and losses should be presented separately from other revenue and expenses in the income statement" (A.I.C.P.A., vol. 2, p. 9102 CCH Ed. 1972).

(ii) The pattern of dealings between the parties which underlay these earnings summaries also created disclosure responsibility as to the inclusion of investment income. When Faggen commenced negotiations with Kaufman (Sept. 6) just four weeks before writing up his summaries (October 7), he supplied Kaufman with the Diebold memo showing adjusted earnings for 1968 alone, and plainly excluded investment income. Investment income was treated as a separate category of earnings for each corporation on these "adjustments" in Faggen's handwriting; each segment of the detailed adjustments says "Deduct Investment Income," see key [a]:

[Ex. 1 (1342), The Diebold Memo]

Adjustments

	Net Per [Tax] Return		$288,494	[H. Faggen
[a]	Deduct Investment Income		31,905	Associates, Inc.]
	Balance		256,589	
	Add Back—State and City Income Taxes		14,820	
	Total		271,409	
[d]	Salary Adjustment — (Loan at 6/30/68)	$25,700		
[b]	Pension Prepayment	58,108		
[d]	Salaries Pd. to 12/31/68 (Can be treated as loans)			
	Rose [Dogan Faggen]	22,950		
	Geo[rge Stewart]	13,162	119,920	
			391,329	[$391,329]
	Employee Fund Services F.Y. End 7/30/67			
	Net Income		21,597	
[a]	Deduct Investment Income		2,652	
	Balance		18,945	
	Add Back State and City Income Taxes		2,855	
			$ 21,700	21,700
	Act. Tab.—Fiscal Y. End 3/31/68			
	Net Inc.		40,045	
[a]	Deduct Invest. Income		10,756	
	Balance		$ 29,289	
	Add—State and City Income Taxes		3,814	
			33,103	
	Salaries		12,000	
[b]	Pension		6,348	51,451
	Fund S & E Corp.—F.Y. End 6/30/68			
	Net Inc.		10,416	
[c]	Special Work in Process		3,500	13,916
	....			.....
	Personal Accounting Services			35,280
[c]	Special Work in Process			25,000
				.....
[e]	Expense Items that will not recur			32,800
				$571,476

(Other keyed items are referred to *infra.*)

Thus $571,476 in adjusted earnings was reached on September 6, 1968 by deducting investment income and $571,262 in earnings was reached on October 7, 1968 by leaving it in,

albeit unidentified as such.[1] Both presentations of adjusted 1968 earnings are in Faggen's own handwriting, and the later one does not make any mention of his unilateral change of ground rules.

Faggen had wanted a separate payment for net worth. Attorney Kaufman's contemporaneous notes of this September 6, 1968 conference state Faggen's negotiating demands as "Deal proposed by Faggen is at not less than 20 times earnings [equal to 10 times pre-tax earnings] + net worth with earnings excluding investment income" (1378) in addition to ten times his adjusted earning power of $571,000. Kaufman says he refused to pay this because "we expected the net worth to be part of the package if we were paying that high a multiple for his earnings . . . the figures specifically excluded investment income . . . the way in which I characterized my offer to him was ten times approximately $550,000 of operating income" (134). "Whatever multiple we were talking about—we were not including investment income as part of the computation" (123).

(iii) Finally, all the copies of the typed selling memo in Titan's files complete the story (Exs. 3, 3A, 3B, 1371). Each says right under its title, "excludes investment income," in the handwriting of President-Director Frank, or the phrase "without investment income" handwritten by Chairman Robinson (1371, 1373, 1376). Frank's testimony was: "Q. Do you recall any conversation with Mr. Faggen in connection with your writing 'excludes investment income' on the fourth page of the exhibit? A. Well, when I received this Exhibit A as it is called here, I had heard, of course, that the pretax earnings of this firm were about $550,000, and I just wanted to double check, or triple check, I suppose, this, . . . excluded investment income, because I knew he had an investment

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[1] The total investment income deductions on the Diebold memo are $45,313, but the audit of the tax return income (not in dispute) showed 1968 investment income was even higher—$51,777 (564, 1385-1388).

portfolio. So I asked him" (277). Robinson also said he wrote in "without investment income" (336-337). The Court held *both* of these notations were equivocal, because of the following testimony by Robinson alone (questioned by Faggen's lawyer): "Q. Now, with respect to the memorandum, Exhibit 3, the words which appeared, I believe you testified, 'exclude investment income,' were in your handwriting. A. I said it looks like my handwriting. Q. Did you have a discussion with Mr. Faggen as to whether or not these adjustments include or exclude investment income? A. I have no recollection. Q. Do you know from whom you got that information? A. I don't know whether I got the information or whether I was raising a question. I don't seem to recall that" (367-368). But Robinson notwithstanding, Frank, as shown, did recall why he wrote in the exclusion.

The earnings schedule with Robinson's handwritten "without investment income" also appeared in the files of McIntyre, Titan's chief accountant (and a director who voted for the acquisition), as part of his own handwritten 1968 working notes on discussions with Faggen (Ex. 3B, 1376, 1445). Titan accountant Russo also had such a copy he worked from with such exclusion written in (449-450, 1376). The Court below attached no significance to these several copies of the key earnings summary in possession of four executives of Titan. Without invoking the "clearly erroneous" concept to reject such finding, does Robinson's less then disinterested failure to convince the trier of fact (to whom "the picture is not entirely clear") overcome Faggen's clear duty of disclosure implicit in showing $571,000 in earnings to Titan that excluded investment income on September 6, and showing $571,000 in earnings on October 7 which included such extraordinary income? Was not Faggen under a duty to disclose his unilateral change of ground rules (ignoring, arguendo, Frank's unequivocal testimony quoted, that he asked for and was given a clarifying answer)? If, as the Court below held in effect, there was no clarifying answer, the skilled accountant-proponent of these figures who saw the distinction once and identified investment income as a sepa-

rate category of earnings in the Diebold memo had the duty to clarify the same $571,000 in earnings in the selling memo. See S.E.C. ASR # 62, 4 CCH Fed.Sec.L.Rep. Par. 72,081 at p. 62,149 (1947); a footnoted explanation must be included in a summary earning statement if the information it would contain is of such "special significance [that] . . . its omission would be likely to give rise to misleading inferences," cited in *Republic Technology, etc. supra,* at p. 547. Or see *Metropolitan Personal Loan Corp.,* 7 S.E.C. 234, 239 (1940), holding that where a deferred asset account could be written off in a single year, a footnoted explanation was required to make the income statement not misleading; failure to disclose fully by footnote a change in the method of handling an income account rendered the statement misleading. *Rappaport, supra,* at p. 16:16 concurs, as does A.P.B. Statement No. 4, par. 199, *supra.*

See *Bowman & Bourdon, Inc.* v. *Rohr,* 296 F. Supp. 847 (D. Mass. 1969), affd. p.c. 417 F.2d 780 (1st Cir. 1970), cited with approval in *Republic Technology, etc., supra.* In *Bowman & Bourdon* the seller in a merger was an accountant who provided, like Faggen, unaudited earnings figures. A Rule 10b-5 violation was found in the seller's failure to disclose he had reached his recent earnings figures by making undisclosed adjustments in his inventory valuations. While validity of the unit cost adjustments were merely questionable, the failure to give sufficient explanation to the buyer so he could decide that for himself was the crux of the 10b-5 violation found. The Court said: ". . . where the total inventory figure here is misleading unless details as to how it was computed are revealed, the law imposes on Rohr the positive duty to disclose sufficient additional information necessary to make the figures supplied not misleading . . . The October financial statements of Drew do not show any real operating profit, but only an apparent profit due to Rohr's price adjustment." A similar face-to-face Rule 10b-5 violation in a merger transaction, with a sophisticated buyer, is *Value Line Fund* v. *Marcus,* (S.D. N.Y. 1965) CCH Fed.Sec.L.Rep. 64-66, Par. 91,523, p. 94,966; "Nonetheless there can be no question that the adjustments were inconsistent with previous accounting

practices employed by Hoffman and therefore misled the plaintiff . . . Basically what Holzman (accountant) did was to change liabilities and reserves into income, and expenses into assets. As a result, Exhibit 1 inflated earnings." The Court found common law fraud as well as Rule 10b-5 liability in the omissions to disclose. Also see *Royal Air Properties* v. *Smith,* 312 F. 2d 210 (9th Cir. 1962), for another private selling memorandum omitting to tell the whole story.

(iv) The Court below indicated its own perplexity over Faggen's figures, saying "I cannot see how you could get $571,000 on any other basis except including investment income for 1968" (38a). But the deal was first presented to Kaufman on September 6 in the Diebold memo quoted above in just the way the Court below found to be impossible.

A final item of documentary evidence caps this point. Faggen wrote up a ten year income projection, in his own handwriting (a third memo), plainly separating operating income of $570,000 from investment income the first year, and each year thereafter, and furnished it to Robinson while negotiations were in progress. Frank reviewed this projection as well (Ex. 8, 1382, 280-282, 299). This document shows that Faggen was leading Titan to believe he was excluding investment income from the $571,000 presented on a pro-forma basis for 1968, and for the earlier years in the selling memo. This handwritten projection showing operating income and investment income separately, also indicates Faggen's awareness of the significant distinction, as follows:

"Income Projections—Assuming that Current Business Will Increase 5% a Year and that New Business Will Come In At a Rate of 10% a Year . . .

000 omitted

Fiscal Years Ending In	*1969*	*1970*	*1971*	*1972*	*1973*	*1974*	*etc.*
Volume Preceding Year	1095.0	1150	1322.5	1509.4	1711.9	1931.5	
Increase [current business] . . .	55.0	57.5	60.4	63.4	66.5	69.9	. . .
Increase [new business] . . .		115.0	126.5	139.1	153.1	168.4	
Total	1150.0	1322.5	1509.4	1711.9	1931.5	2169.8	. . .
Pre-Tax Profit Preceding Year		570.0	644.7	725.5	812.8	907.2	
TOTAL PRE-TAX (OPERATIONS ONLY)	570.0	644.7	725.5	812.8	907.2	1007.5	. . .
INVESTMENT INCOME	130.0	145.0	160.0	180.0	200.0	225.0	. . .
Total	700.0	789.7	885.5	992.8	1107.2	1232.5"	. . .

(emph. supplied, Ex. 8, 1382)

The base year in the projection (1969) shows the same $570,000 result as 1968 in the selling memo (specifying it as "Operations Only") because, as Frank said (301-302a), "the figure for 1969, 570, was deliberately picked as being flat from 1968," because "Mr. Faggen felt that the time and effort required to bring the computer projects on stream would make 1969 earnings flat." The Court below paid no attention whatever to this second writing (the first was the Diebold memo) where Faggen did make the distinction the law requires between operating and investment income. Moreover, this memo projecting income forward in such detail tells the story of how Faggen presented himself to Titan. The earnings expectations presented there were not written up as an idle gesture. This projection was unknown during two years of discovery, and popped up in Chairman Robinson's files just before trial—Faggen admits writing it, but apparently never had a copy to supply when his writings were subpoenaed (338, 996-997). Titan's present management had to subpoena the 1968 records of its own counsel and Chairman to first discover this pivotal writing by Faggen.

In sum, Faggen's failure to disclose in the selling memo that he was charging Titan ten times $52,000 in investment income in 1968, i.e. $520,000 in notes for Faggen's stock market expertise, and each year's substantial similar investment income ($200,000 over the 4 years), was a material omission. His omissions alone on this point are sufficient for liability. But all the documentary evidence actually points in the direction that in 1968 Faggen intentionally misled Titan's directors-executives into believing he had excluded investment income from the 1965-1968 pro-forma presentation. The handwritten notations "excludes investment income" on all Titan's copies of the selling memo (1371, 1373, 1376), stand in a bright light when Faggen himself wrote the same words for the same essential figures—$570,000—on his ten-year projection forward. Thus there is $52,000 in undisclosed investment income in the total of $221,000 in positive earnings "adjustments."

b. *Omissions to Disclose Non-Recurring and Negative Aspects of the Other Adjustments.* Titan's accountant

(treasurer—director) McIntyre discussed the general nature of the adjustments with Faggen in November, 1968, but only with respect to 1968 alone, and nothing in writing was provided on these general discussions (1468-1471). But a 1972 audit of Faggen's earnings for 1965-1968 (the first audit done for such a period), which led to this suit, showed that certain of Faggen's adjustments for the Diebold memo and the selling memo were invalid accounting techniques, and several were made of whole cloth, with both the techniques and the numbers invalid. Moreover, negative adjustments were omitted. Titan's accountants attempted to audit giving effect to adjustments on the same accounting basis as was sold to Titan. The results showed the following overstatements by Faggen (Ex. 10, 1384):

NET INCOME—PRE-TAX
ADJUSTED TO BASIS WHICH PREVAILED
AFTER ACQUISITION.

	Fiscal Years Ending During			
	1965	*1966*	*1967*	*1968*
Total adjusted net income—pre-tax per Titan audit	$261,310	$303,339	$336,395	$403,721[1]
Total represented net income—pre-tax per Faggen	380,802	490,754	451,885	571,262
Overstatement	$119,492	$187,415	$115,490	$167,541

The overstatements of income from 1965 through 1968 are 46%, 62%, 35% and 41%, respectively. From adjusted earnings represented as $571,000 in 1968 (but actually $403,721), the Faggen Companies thereafter deteriorated rapidly, earning $260,000 in 1969, $192,000 in 1970, $136,000 in 1971 and a loss of $125,000 in 1972 (Ex. 11, 1389). To an accounting expert the subsequent performance trend supports the conclusion that the 1965-1968 figures were greatly overstated (579). The explanations given by Faggen

[1] The $403,721 is higher than th[illegible] $350,000 base (see p. 12) because valid adjustments for taxes and salaries were credited to Faggen; the invalid adjustments are discussed *infra*.

during his three years of tenure on Titan's Board and as an important subsidiary head were that the increased revenues from his new computer operations were being more than offset by high start-up costs for the new customers and that soon he would be on-stream and back to profitability (153-154A #73-1345, 1401, 1402, 1403). The figures show that he never had the profitability of $571,000 represented in 1968, and that his business was much smaller in scale than indicated. The Court below rejected Titan's audit of the Faggen Companies, "because they made certain assumptions . . . which I do not find supported clearly" conceding "that the figures advanced by Faggen in the fall of 1968 didn't prove out to the dollar. That I think is probably true, but I think any shrinkage from the $571,000 was far less than what plaintiff here claims which is the difference between some $404,000 and $571,000 (39-40a). That finding, which incidentally ignores the 35% to 62% distortions of the other three years, in showing the true earnings and trend of the Faggen Companies is based upon an erroneous application of Rule 10b-5. Acceptance or rejection of Titan's audit figures is not controlling. We submit that the issue of law is simply whether there were undisclosed adjustment techniques, or invalid techniques or figures, used to reach Faggen's totals, and whether they were individually, or taken as a whole, material. As shown in (a) preceding, the undisclosed inclusion of a substantial amount of investment income was violative of Rule 10b-5. We now turn to the other items using only undisputed numbers.

A merger customer is "at least entitled to assume that the interim [or adjusted] financial statements furnished them by . . . the other party to the merger will give them better than 'ballpark' figures and be based on principles of conservatism . . ." *Republic Technology, Inc., etc., supra*, at p. 547. Disclosure of any effect on an income statement should be made "if a change in accounting principles or practices or methods or their application results in an increase or decrease in net income or loss of 5 per cent or more." S.E.C. Guide 22, CCH Fed. Sec. L. Rep. § 3782.

The Court below emphasizing its belief in lack of reliance, fastened on an assumed statement in McIntyre's deposition that "our real concern . . . was to look at enough to make sure that these pro-forma figures were within the ball park" (40a). The testimony (from this witness engaged by Faggen) was much more pointed than that, however: "Q. Did Tony Frank indicate to you any doubt about the reality of the figure of $571,000? A. My recollection is that, you know, check this out and see if it is reasonable . . . Q. Did you accept the figure as reasonable? A. After my discussion with Faggen it seemed to be in the ballpark, yes" (1478). A. "I knew that they were talking about earnings in excess of $550,000 in the general area. Q. Right. And you knew that is what Titan was looking for in the deal; is that right? A. That's right" (1468). Thus notwithstanding the mistaken recollection of this transcript by the Court below, the McIntyre (and Titan) ballpark was plainly "in excess of $550,000."[1]

(i) *Pension Overfunding.* Faggen added in $64,556 of income for 1968 to reflect his claim that he overfunded the pension plan for his companies, and still undisclosed, but we assume similar amounts, to earnings for the earlier years 1965-67. The $64,556 adjustment increasing earnings for 1968 was excessive, because audit revealed a continuing annual pension cost of doing business in the Faggen Companies (contributions were 1965—$21,000, 1966—$33,000, 1967—$69,000 and 1968—$64,000) (561, 1385-1386). Even if there was a sound accounting basis for increasing 1968 income in some amount, it was non-recurring and disclosure of that fact should have been made. Faggen was assuming, without disclosing it, that there was no future pension cost in any amount. He did the same thing on the Diebold memo (see key [b] on such memo at p. 15, *supra*). But it was factually impossible to "save" $64,000 annually for the next ten years, and adding it into income being marketed at ten times was misleading. Moreover, the

[1] McIntyre resided in Georgia, was not available at trial and his deposition went in as evidence, permitting review herein of the same material as the District Court (Ex. 27, 1417).

assumed "hidden earnings" were unreachable for corporate use. They were locked in a pension trust fund for the benefit of employees, and only cessation of business and cancellation of the trust could free up these "hidden" earnings added into the pro-forma statements (827-828, 563, 715). Profit is not realized if "the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition . . ." S.E.C. A.S.R. #95, CCH Fed.Sec.L.Rep. Par. 72,117. This second major item in the $221,000 of "adjustments" was thus non-recurring and unreachable.

(ii) *Disregard of Negative Adjustment.* Moreover, Faggen did not disclose that offsetting the unrealizable income from pension accruals was a substantial hidden charge reducing income—the vacation plan accruals. The vacation plan had a $59,000 accrued liability in October 1968, which was not charged off against adjusted earnings presented to Titan, and should have been (596, 714-715, 543, 545, 491-496). $36,000 of this sum was Faggen's and his wife's accrued vacation claims, and they waived these past accruals when the liability showed up on the closing balance sheet. But Faggen made no disclosure or compensating reduction in the adjusted income, to reflect this future, ongoing vacation plan cost of doing business, or for the remaining $23,000 still owed to other employees. Faggen and his wife are suing Titan right now for substantial vacation plan accruals since 1968 (1003). The "adjustments" thus omit a substantial negative item, contrary to the rule of disclosing "the bitter with the sweet." *Republic Technology Fund* v. *Lionel Corp., supra,* at p. 547. For these reasons, in Titan's audit no credit was given for the claimed pension overfunding and no charge was made for vacation plan costs, except a nominal charge ($4,000 in 1968 and lesser sums in 1967-65) for past accruals remaining unsatisfied—justifiably treating these two items as mutual offsets.

(iii) *The Diebold Memorandum Adjustments.* Faggen conveyed other specific 1968 adjustments he had in mind in

his Diebold memo (p. 15, *supra*), and on examination, several such items evaporate quickly.

1. A $25,000 addition to 1968 income for accrued "Special Work in Process" (see key [c] at p. 15, *supra*) turned out to be a receivable for a contingent consulting fee, nonrecurring and payable to Faggen only if litigants were successful in a case where he was helping as an expert. No disclosure was made as to the potentially unrealizable, irregular quality of this item of "income" (81). It was disregarded in the audit (along with a similar $3,500 item of "Special Work in Process"). When audited in 1972, the $25,000 income item had still not been collected (497), and in 1972 Faggen himself admitted the $3,500 item was an undisclosed expenditure, capitalized "programming costs" added into earnings (479A #73-1345). Thus $28,500 in "work-in-process" earnings was just air, parallel to the "arrangements to increase . . . receivables, sales and earnings by amounts not collect[ible] in cash in the normal course of business" held deceptive in *Value Line Fund* v. *Marcus, supra,* at p. 94,967. In sum, this was a false adjustment, as well as suffering from inadequate disclosure of its non-recurring nature.

2. Some $61,000 was added to income on the Diebold memo by treating the fiscal 1968 salaries paid to Faggen and two executives as "loans receivable" for 1968, because Faggen prepaid salaries in calendar 1968 for the whole fiscal year ending June 30, 1969 to increase tax deductions in fiscal 1968. See key [d] at p. 15, *supra.* But audit in 1972 showed that these executive salaries (including Mrs. Faggen's salary) were a substantial ongoing cost of doing business each year, and that pre-payment for some tax advantage in 1968 did not create any real income (496-497, 1024-1025). This illusory item was disregarded in the audit. It shows up in another form with a slightly lesser effect as "salary savings" (pt. iii, *infra*) in the selling memo adjustments.

3. "Expense items that will not recur" of $32,800 was added to 1968 income in the Diebold memo (see key [e])

to reflect assumed savings of personal expenses for a boat, travel, entertainment, etc. that would not be incurred after acquisition. But these expenses did recur, for when audited in 1972, the travel and entertainment expenses of the Faggen Companies did not show any substantial reduction in magnitude from 1968 onward; Faggen did much as he pleased with two cars, credit cards, etc. presumably because they were ordinary and necessary business expenses. This increment to earnings he assumed had never materialized (498). Faggen actually increased this artificial income item by over $5,000 to $37,574 for 1968 (note the precision of expected reductions), he claims, in his pro forma summary for the selling memo, because "they [Diebold] indicated that their control of expenses would have been less rigid than the controls Titan would have exercised" (Faggen aff. 482A # 73-1345). No credit was given in the audit for these non-existent savings over four years, and fair disclosure required some valid explanation of the assumptions giving rise to such precise anticipated savings.

4. The Diebold memo was indefensible once the litigation and audit showed its watered adjustments, and Faggen went to great lengths at trial to show that even though he gave this memo adding up to $571,000 in earnings to Kaufman, he told Kaufman to disregard it (64-82, 998-1000). This is an inherently incredible contention, where Faggen asserts "I told him [Kaufman], sir, they were ridiculous and that I was . . . *The Court:* In so many words *The Witness:* In so many words, I was disgusted with Rogov [Diebold executive] even wanting to make them . . ." (80). Faggen had spent 12 pages of a 1972 summary judgment affidavit saying exactly the opposite, "why they [the selling memo and Diebold memo] are by no means contradictory and why they are both precisely accurate" (483A, 471-483A #73-1345). Kaufman's testimony was that the Diebold memo was given to him without any caveat of unreliability or "disgust" as now claimed by Faggen, and was read and relied upon as a set of "reasonable, realistic and accurate adjustments" (121). Kaufman's con-

temporaneous notes show the Diebold negotiations and the ten time earnings offer by them were taken seriously (1377, 113, 116-117).[1] Do sellers generally give buyers detailed accounting memos with glowing results and say "Don't pay any attention to this?" No finding of fact was made on this point by the District Court.

If a seller gives an earnings summary, the selling memo, which does not contain any explanatory notes on the adjustments used to increase reported earnings, can he not expect the securities purchaser to place some credibility in a prior list of adjustments given 4 weeks earlier for the most recent year—the Diebold memo? Both yielded $571,000 in adjusted earnings for 1968. A written explanation for one year, plus a summary for 4 years implies that the adjustments for all 4 years are generally alike—particularly adjustments which deduct investment income, give credit for accrued work in process and add in salary adjustments. Even now, *most* of the adjustments relied on by Faggen to validate the selling memo for 4 years are the same adjustments as are in the Diebold memo (adding on state taxes, pension overfunding, expense account savings). Only a few key adjustment items are different—$52,000 in investment income, $28,500 of work-in-process, and revisions of salary savings and expense account savings in minor amounts. Fair disclosure required Faggen to identify those to Kaufman and Frank in his negotiations, with the same degree of written specificity as he brought to the Diebold memo, which he now tries so hard to peel from his fingers. This was an artificial presentation given at the first negotiating session, and none of Faggen's written summaries that follow with the same bottom line for 1968—$571,000, ever reject any of the Diebold memo's items. Even his ten year future projection (p. 19, *supra*) starts with $570,000 as the base year, but with no identification that this total is reached a

[1] This was the second time Faggen tried to cast aside a damaging memo he wrote. Earlier he said the selling memo given to Frank for the Board's approval a week *after* the handshake with Kaufman, was provided "at a preliminary stage of our discussions," (46A #73-1345) attempting to minimize it in an affidavit.

different way from the selling memo or from the Diebold memo, all written in longhand by the same defendant and furnished to Titan's executives in the negotiating period. Faggen's manipulation of these three similar handwritten presentations bears an unfortunate resemblance to the old "shell game" in a circus, with investment income buried under the middle shell (the selling memo), but the buyer left to figure it out for himself.

(iii) *The salary savings added to income.* Faggen claims that he added back salaries saved by reducing his to $50,000 annually, and reducing Rose Dogan Faggen's to $40,000, to increase adjusted income for the years 1965-1968 in the selling memorandum (472-473A #73-1345). This accomplished the identical positive effect on earnings for 1968 as did the fallacious "loan" concept in the Diebold memo (omitting employee Stewart however). Titan's audit in 1972 gave effect to the savings above $50,000 on Faggen's actual salaries paid in each year—but overstatements of actual income still resulted in the large amounts of 35% to 62% discussed above. No credit was given in the audit for assumed savings in Rose Dogan's salary because there was no firm contract reducing her salary from $49,500 to $40,000 under discussion on September 6 or on October 7, 1968, when Faggen supplied the Diebold and selling memos (682-683). Her projected salary cut was mentioned to president-director Frank for the first time in December, 1968, weeks after the selling memo (277A #73-1345). More important, the assumed salary cut yielding 10 times its adjusted effect on earnings ($95,000 in Notes), never occurred. Faggen fully controlled the salaries within his organization, they were not locked by contract, and the soon to be Mrs. Faggen received $50,000 salary in 1969, rising to $55,000 in 1970, $55,000 in 1971 and $71,412 in 1972 (1392, 1394). She first testified that her salary "was reduced when the merger took place," but when confronted with salary-pension ledgers in her own handwriting, she admitted the higher salaries in 1969 and seq. (719), later saying that she took a cut for six months and was reinstated to $50,000 "retroactively" (738). Instead of giving himself back the salary reductions he had sold at ten times,

Faggen gave them to his wife. There was a duty to disclose that this earnings increment arose from an assumed savings, not the subject of a fixed employment contract, and could evaporate as it did, if Faggen made any voluntary change in her salary.

(iv) Pulling this together, Faggen moved from a combined $350,000 in reported taxable income up to $571,000 in adjusted income—a $221,000 increase for 1968 by the several items discussed (plus other adjustments not in question). Totalling up the watered earnings adjustments, they are (i) $64,000 in claimed pension overfunding in 1968, and similar amounts in other years, with an undisclosed *negative* adjustment of $59,000 for vacation pay (ii) $37,500 for 1968 in non-existent expense account savings, carried out four years in an unspecified way, (iii) $9,500 in non-existent salary savings on Mrs. Faggen, carried out in an undisclosed way over the other years and (iv) $52,000, in undisclosed 1968 investment income, discussed earlier. That totals to $163,000 in inadequately explained or downright non-existent "earnings" for 1968 in the selling memo, and at least that for the three preceding years. The Diebold memo has two of its own special types of invalid adjustments for 1968 alone, (i) $61,000 in artificial loans receivable from salary prepayments and (ii) $28,500 in unbilled work-in-process which was not realizable as profit. Each of these six items comes from Faggen's claimed adjustments (472-483A #73-1345), were measured by the cash basis tax returns ultimately audited in 1972, and the numbers are not in dispute (564, 1385-1388). We exclude Titan's audit of overall adjusted income (1384) as, arguendo, irrelevant. Examining only *Faggen's work product,* it is plain that a "change in accounting principles or methods or their application" (S.E.C. Guide 22, *supra*) resulted in this $163,000 in increments to 1968 earnings, and the changes were not fully disclosed. And where are the missing adding machine tapes (83-85), or any other form of explanation for the other three years? The overstatements found in the audit for four years, regardless of their exact magnitude, flow from these undisclosed accounting applications. The watered items far exceed the touchstone "in-

crease . . . of net income . . . of 5% or more" for each item, "considered separately" set out in S.E.C. Guide 22, *supra,* for disclosure of the results of accounting adjustments in summary of earnings statements. *Rappaport's* treatise, *supra,* at 21:3-4 states the rule of law to be applied here:

> "There has been some abuse of pro-forma financial statements, principally in the direction of stating past financial statements in the light of present or assumed future conditions. To attribute to a past period certain conditions which exist currently, or which will exist in the future and, at the same time, to ignore other changed conditions may be misleading. Such adjustments of earnings should ordinarily be avoided, but if used, the statements should clearly disclose the adjustments that have been made."

It was Faggen's duty to be correct, complete and reasonable in his adjustments and to fully disclose questionable items—and he failed in such duty. The duty was accentuated because he refused to allow Titan's outside auditors (Peat, Marwick, etc.) into his books, claiming they were competitors (153). As an accountant presenting a private business, with many claimed adjustments that, back in 1968, were essentially unauditable, Faggen made Titan particularly dependent upon his candor and completeness. Liability is not avoided "on the basis that they [defendants] did not provide the right answers because they were not asked the right questions." *Stier* v. *Smith,* 473 F. 2d 1205, 1208 (5th Cir. 1973). "Availability elsewhere of truthful information cannot excuse untruths or misleading omissions in the" selling memo, and "readiness and willingness to disclose are not equivalent to disclosure." *Dale* v. *Rosenfeld,* 229 F. 2d 855, 858 (2d Cir. 1956). By a series of unarticulated overstatements, a small $325,000 pre-tax business (actual average over 4 years) was blown up to look like a $500,000 earner, with annual growth figures far in excess of reality, and $570,000 in the latest year. The figures belonged in an amusement park mirror. The Court below emphasized earnings shortfall in 1968 to the exclusion of the overall misleading impression of Faggen's

four year presentation. The fair value of the Faggen Companies was a long way from $5.5 million in Notes now being enforced at their full face amount.

2. *The Failure to Disclose Lost Clients and Special Risks of Additional Loss of Clients.* The selling memo was requested by Frank and Kaufman for use at Titan's Board meeting October 9, 1968. Faggen says, "He [Kaufman] asked that I draw up something in a table on the clients and the length of time they had been there . . ." (984, 43). The following is what Faggen supplied as Exhibit B to the selling memo (1366, 1372):

"Analysis of Clients

	Pension Funds	*Welfare Funds*	*Other*	*Total*
New in 1968	2		2	4
New in 1967	3	1	3	7
New in 1966	5	1	1	7
New in 1965		1	1	2
New in 1960-64	19	14	2	35
Began Prior to 1960	49	36	3	88
	78	53	12	143"

The memo itself also says "As shown in Exhibit B, attached, there are 143 clients, most of which have been clients continuously for more than ten years" (1362, 1368).

(i) The memo lists only new clients and does not disclose that in the year ended July 30, 1968, nine clients were lost with gross billings of $96,700, and in 1966-1967 three clients were lost with $6,800 in billings (1396, 752-753). This totalled 12 clients for $103,500 lost in gross revenues in a personal service business grossing $1,085,025 in the year ending June 30, 1968, and lesser amounts in prior years. Costs and expenses of the main corporation in 1968 were $663,472 and in 1967, $673,472 (1385), so without any material diminution in overhead, Titan would have justifiably concluded, if it knew these facts, that, 10% of the existing business had evaporated by mid 1968, and was bound to affect 1969 earnings by as much as 20%. If full disclosure had been made, Titan would further assume that the Faggen

Companies' current operations in October 1968 were necessarily beginning to feel this drop in revenues and earnings at the time they were being sold. There might have been an arguable explanation—perhaps the clients lost were made up in revenues, if not in number, by new clients in 1968, or perhaps revenues from existing clients were increasing sufficiently to make up the lost volume. But Faggen was silent on the negative facts and gave no explanation at all, even to this day.

The Court below said of Faggen in its findings, "The core of his business success then was the acquisition and retention of many clients, particularly unions in union pension funds and insurance business" (8a). But in ruling on this omission to disclose, the Court went off on the reliance issue, saying "Whether it was 140 clients or 70 clients and whether Harold Faggen had lost ten percent of his clients the year before or was about to lose 20 percent of his clients, they [Titan] couldn't care less and nobody kidded anybody on that score" (34a). There are no facts to support this conclusion, but the Court's attitude on the materiality of a 10% drop in revenues with its 20% adverse effect on earnings is shown by its comment, "Suppose I were to sell you my law practice. Would you expect me to sit down and write a memo and tell you about all the clients I have lost? This is kind of absurd" (1067).

To the contrary, it is the Court below's view of disclosure requirements on a material adverse change in revenues and income, implicit in a loss of clients, which was incorrect as a matter of law. Two elements of the disclosure philosophy of the federal securities laws are relevant here. First, once a disclosure is made, on any material aspect of a business, it must be complete, so that omissions from the disclosure do not give a misleading import to what is stated. See C.J. Lumbard's opinion in *Maher* v. *J. R. Williston & Beane, Inc.*, CCH Fed.Sec.L.Rep. Par. 93,457 (—— F. Supp. ——, S.D.N.Y. 1972), holding that failure to present a complete factual portrait means that a securities purchaser is "deprived of the opportunity to judge the wisdom of his investment in light

of all the facts to which he was entitled" (failure to disclose the mere possibility of non-existence of salad oil securing notes receivable, raised by an undisclosed letter from an accountant suggesting further inquiry be made). Once Faggen opened the door to the facts of his progress each year in his main endeavor, the "acquisition and retention of many clients," giving numbers for each type and glowing totals through 1968, he assumed the duty of disclosing the clients he had lost. Just as the substantial accounts receivable in the *Maher* case implied a duty to disclose the existence of a letter merely questioning the security for such receivable (suggesting no more than inquiry), Faggen's detailing the new clients herein required disclosing any material loss of old clients. In the sale of securities, a trained lawyer-accountant, in particular, must disclose "the bitter with the sweet," *Republic Technology Fund, Inc.* v. *The Lionel Corp., supra* at p. 547. When a skilled accountant, accepted as such by the Titan board, presents only items with a positive impact, the duty to show lost clients is even greater, because the purchasers are "being shown the frosting on the cake with no allusion in the statements to the fact that a substantial part of the cake itself was dried out, if not mildewed." *Republic Technology, etc., supra,* at p. 546; quoting *Globe Aircraft Corp.,* 26 S.E.C. 43, 46-47 (1947).

The second disclosure principle is that any event which has caused, or could reasonably be anticipated to effect, a material adverse change in sales or earnings stands on the highest rung of the ladder of required disclosure. See *Securities Exchange Commission* ("S.E.C.") Form 10-K, the basic annual disclosure requirements for all reporting companies, Item 1(a) and (b): "(a) Identify the principal . . . services rendered . . . and the principal markets for . . . such services. Briefly describe any significant changes in the kinds of services rendered, or in the markets . . . since the beginning of the year. (b) Describe any material changes and developments . . . in the business done and intended to be done . . . include matters such as . . . (2) If a material part of the business is dependent upon a single customer or a few customers [i.e. can the loss of 9 be

made up by only 4?], the loss of any one or more of whom would have a materially adverse effect on the business . . . the name of the customer or customers, their relationship, if any, to the registrant and material facts regarding their importance to the business . . ." CCH Fed.Sec.L.Rep. Par. 31,103, p. 22,055, repeating the language on customers of Form S-1, item 9(a)(2) "Description of Business", the basic S.E.C. form for describing any business and the model for nearly all S.E.C. disclosure forms. Similarly, see S.E.C. Guide to Reg. Statements, #22, *supra,* "To enable investors to understand and evaluate . . . changes in . . . items of the summary of earnings. [explain] (1) material changes in the amounts or items of revenues . . . This discussion is necessary . . . to assess the source and probability of recurrence of earnings (losses). If any facts are known . . . which would indicate . . . historical earnings are not indicative of present and future earnings, these facts should be discussed . . . the following are examples . . . 7. The closing of a material facility, or other material interruption, or completion of a material contract, or *any event that will materially reduce revenue in subsequent periods."* (emphasis supplied). The S.E.C. Guide even defines the magnitude of such change deemed material, i.e., "if any income or expense item set forth in the summary . . . increased or decreased by more than 10 percent," with each decrease considered separately. But even if the item doesn't meet the 10% change magnitude, but can still be material to an understanding of earnings "in such event, appropriate disclosure should be made." CCH at p. 3317.

In a personal service business, so much like a law practice, lost clients go to the heart of revenues, cash flow, earnings and future prospects which justify paying 10 times pre-tax earnings, i.e. $10 in Notes for every $1 in pre-tax earnings. Such capitalizing of future results implies continuity of the earnings at least for ten years. Moreover, this high multiple (20 times after tax) was justified only by a "growth" stock, and in his handwritten 10 year projection (Ex. 8, p. 19, *supra*) Faggen himself held out substantial, rapid growth so that Titan at ten times present earn-

ings had the chance of recouping its investment in far fewer years than ten. Instead, the Faggen Companies were having to scramble for new clients merely to stand still, because of the undisclosed 10% loss of clients, primarily in the year ended June 30, 1968. The purchasers "are entitled to assume that uncertainty concerning profit or loss should be at least footnoted in the first financial statement issued after the uncertainty arises," *Republic Technology, etc., supra,* at p. 547. A summary of earnings with a specific client list was even more pointed than an overall financial statement; it was listing clients as "assets" without telling liabilities, i.e. problems affecting them. The ten year projection (p. 19, *supra*) is headed "Assuming that Current Business Will Increase 5% a Year and New Business . . . at . . . 10% a Year," but Faggen knew this assumption was false when written, because he had lost 10% of current business and needed a 25% increase to make the projection reasonable even in its first year. This deception casts light on the deception in the selling memo, in the same way the First Circuit put together the jigsaw of concealed changes in business prospects in *Janigan* v. *Taylor,* 344 F. 2d 781, 785 (1965).

(ii) Other factual omissions on the client list are relevant. The biggest single client of the Faggen Companies, the Carpenters' Union, with $78,000 in annual billings (1396, 761, 750) was lost in 1968. This was a New York area construction trade client, the primary source of clients to the Faggen Companies over their corporate history (751). This was not disclosed. Nor was there disclosure of other New York clients where potential loss of business was currently foreseeable. The Mason Tenders Union, a $40,000 annual client (1398) was lost in 1970, but back in 1968 the work of the Faggen Companies as actuaries for Mason Tenders was already under investigation by the New York Insurance Department (1410, 1414, 758). The National Postal Union (a $40,000 client) was lost in 1969, but its anticipated loss through merger discussions with another union was known in 1968 to Faggen's organization, and undisclosed (763). Two Bartenders Union clients were lost by June 30,

1968, and undisclosed, and foreseeably, the remaining three related bartenders' union clients were lost in 1969, this $23,000 in total billings having begun to evaporate before the October 1968 negotiations with Titan herein (1396, 763). Losses in groups of three to five clients at a time, once a given union relationship was severed, were occurring. Rather than the stated 143 clients, "we had really somewhere in the neighborhood of half that number since some unions may have as many as three funds. But they are really the same client" (754). The Court below dismissed this omission to correct the misleading impression of more "clients" than actually existed, and its attendant undisclosed risk of losing clusters of clients at one time, by saying "everybody was relying on the know-how of" Titan's Chairman Robinson, who sat on such pension and welfare funds as a lawyer (46). But that judicial conclusion assumes (without factual basis) that the bare schedule of 143 clients, stating "new in 1968, new in 1967 and new in 1966" did not fool Robinson as well, who testified: "Q. At the time you read this memo did you have any information about the number of clients of the Faggen Companies other than what was in the memo? A. No" and "Q. Any information come to you with respect to that list of clients other than what is in the memo? A. No" (342-344). Faggen's only answer to these omissions is that he had the client ledger out on October 2 and negotiator Kaufman could have gone through its scores of pages and found out the names of the lost clients, totalled the lost revenues, and determined the names, relationships among, and revenues from the 143 remaining clients (1021-1022). *Stier* v. *Smith, supra,* answers this: "We should always be wary of holding that a purchaser . . . who deals with the corporate insider, could have found omitted material facts by examining the corporate books and undertaking other extensive investigations. To do so, is to allow the insider to present prospective purchasers with a mountain of information which they cannot possibly digest and excuse themselves from liability on the basis that they did not provide the right answers because they were not asked the right questions."

(iii) The final deceptive element in the omissions from the list of new clients is the failure to disclose to Titan that one employee, Sol Tabor, who controlled 10% of the remaining clients of the Faggen Companies was disgruntled with Faggen because of negotiations to sell the business without keeping him informed, and because Faggen had passed over the ambitious Tabor for president of the organization, naming Rose Dogan (now Mrs. Faggen) instead (1035-1040). Tabor had demanded to be kept informed of sales negotiations at a May 1968 meeting with Faggen and several worried employees (765-769, 1304), and he had expressed his disenchantment and resentment to Faggen for years before 1968, all undisclosed (1035-40). There was thus no disclosure of Faggen's own lack of control over the clients being transferred, which were the primary asset of his business. Less than two weeks after the Titan closing, Sol Tabor left the Faggen Companies with 32 small clients (mostly New York construction unions—bricklayers, plumbers, pavers, etc.) (1397, 769) totalling another $109,682 in lost billings, and joined the Levin-Townsend actuarial organization with whom Faggen had been negotiating in the summer of 1968 (30, 1034). Faggen minimized the significance of the clients lost in December 1968 to Titan (164-165) and through litigation Robinson recovered some $262,000 from Levin-Townsend, thus putting out this "fire" before its significance to Titan in the overall loss of clients of the Faggen Companies ever came to light.

The defection of Tabor in December 1968 with 10% of the business, coupled with the undisclosed loss earlier in 1968 of 10% of the business, and the undisclosed potential loss of other clients then known (the Mason-Tenders, Postal Workers, and Bartenders unions, totalling $90,000 in billings) meant that over 30% of the actuarial revenues of the Faggen Companies were lost or in jeopardy in October 1968 when Faggen supplied his list of 143 clients, identifying 18 new ones between 1966-1968. In fact, 12 were already lost in 1966-68, six more were already known to be in jeopardy, and a disgruntled employee controlled 32

others. Ex. 19 (1396-1398) shows a $386,922 shrinkage in the $1 million actuarial business of the Faggen Companies between 1966 and 1973, and most of it is centered around $103,000 lost by June 30, 1968, $90,000 in jeopardy by October 1968 and $109,000 lost in December 1968. Where was the growth specifically projected in Ex. 8, and impliedly projected in the selling memo and in the pricing of the deal, supposed to come from? The undisclosed lost clients and the facts relating to potential loss of others were plainly material in number and amount. Even the specific risk of loss by defection of a consultant such as Tabor, was foreseeable, because another disgruntled employee, William Pearl, had left earlier in 1968, taking several clients with him (752), all undisclosed.

We submit that as a matter of law the omissions to disclose quantified facts about the shrinking pool of clients, and past and foreseeable problems with sales consultants, is a material non-disclosure.

3. *The Omission To Disclose The Imaginary Quality Of The Computer Capabilities And Program In Being.* The selling memo says:

> "Since we have both actuarial and computer capacity, we are in the process of programming completely automated pension plan calculations for small and medium size employers. We expect to provide these services to stock brokers, accountants and lawyers only. The availability of packaged pension plan services at very reasonable prices will enable stock brokers to service the pension plans instead of leaving them for the insurance companies. It will also be possible for the thousands of accounting firms throughout the country to service their clients with pension fund advice as the Ostheimer Division of Peat, Marwick, Mitchell services their clients.
>
> "The profit potential [inherent] in our operation makes it possible for us to achieve any reasonable goal we set, while, at the same time, absorbing the additional costs involved in developing new programs. As shown in Exhibit A attached, net profit before tax has

been growing at a compound rate of approximately 15 percent a year." (1369-1370)

The facts were that there was no data processing capability and no program in being for automated pension plan calculations. They were not developed until nearly a year after this memo was furnished to Titan. Computer hardware and skills were minimal; only two low level employees, (the highest paid one earning $16,000 annually) were on the staff and the programmer never did come up with such a program (796-802). There was no data processing capability and no plan available to sell, and no sales effort with either stockbrokers, accountants or lawyers (746-747). It was all in Faggen's imagination. The Court below called this "a little modest puffing" and held that Frank knew there was no program, no sales efforts and no customers, and that this "offered exciting possibilities, but that is all it offered" (42a).

Frank stated that the memo covered the "conversations we had" and Faggen told him: "First of all, he was already in the computer business perforce because he needed them to do his business, and that in the course of his regular business, he had accumulated a data bank of several million persons, beneficiaries of the pension plans he did actual work for, and that it would take relatively little work to meet the demands of his union clients to employ the complete data processing services for those non-union clients, such as dues collection and health administration, I suppose, and other aspects. Those were two of the points. The third point was that Mr. Faggen had the concept, which I grew very excited about, of computerizing the capability of analyzing relatively small corporate pension funds and using that capability with almost no face-to-face contact between the client and the actuary, which is the key to keeping the costs down, as a sales device for, say other CPA's or for brokerage firms" (279).

Faggen himself now concedes the lack of such "capability of analyzing . . . and using that capability . . . as a sales device," or having any program to sell (1012,

1015), e.g. "*The Court:* Did you at any time prior to September 30, 1968, make any sales efforts or promotional efforts with small brokerage firms or law firms in this connection that you can recall? *The Witness:* Sir, I didn't make sales efforts because we did not have it yet . . . *The Court:* Well, promotional efforts. *The Witness:* Promotional efforts, that I did, sir . . . It occurred to me, therefore, that *if I could provide* this service . . . that there *would* be a market for it . . . and I had discussed it with several accountants, sir. I had also discussed with some lawyers, they seemed to have a great deal of interest. I then discussed it with some brokers . . . I had discussed the point on several occasions with Mr. Frank . . ." (1015-1016) (emph. supplied). When asked to name the stock brokers he spoke to, Faggen said "some of the men at Bache that I can recall . . . Q. What lawyers did you speak to. A. I don't recall by name . . . Q. Name an [accountant you spoke to]. A. Buchbinder, Stein and Company for one. Q. Did you exchange any correspondence with them? A. No. Q. Did you send them any promotional literature? A. I did not." The Court asked: "Did you have any available package plans, let's say in September or early October of 196[8]? . . . No, sir . . . I said we were in the process of programming it" (1019). To describe a new product or service as it was described in the selling memo without identifying start-up problems and costs, lack of a program to sell, lack of genuine sales effort because there was nothing to sell and lack of equipment, personnel or know-how to actually put the product into the market, is a material omission as a matter of law. See *S.E C.* v. *Electrogen Industries* (E.D.N.Y. 1968), CCH Fed.Sec.L.Rep. Par. 92,156, "although the promotional presentation has been diluted to some extent as the demonstrations of its untruth accumulated over the months, the impact persists and it remains the aura of the public presentation" of the business. Faggen's computer mystique even pervades Titan's board minutes approving the deal, and its draft announcement (191A #73-1345, 1380-1381). This kind of deception happens too often—glowing descriptions of new ways to make

money without the substantive back-up to make it a real project. See *Texas Glass Mfg. Corp.*, 38 S.E.C. 630 (1958). Frank was expecting only about a year's "time and effort to bring the computer projects on stream" (301-302); thus the written statements in the nature of prophecies rather than of fact were illegal, *Commonwealth Bond Corp.*, 1 S.E.C. 13 (1934). Moreover where are these start-up costs in the ebullient projections of Exhibit 8 (p. 19, *supra*)? The assumptions there stated with such misleading precision for ten year's of rapid growth are silent on charges against income to put the non-existent capability into being. It is clear that Faggen did not fill most of page 2 (more than half the body of the selling memo) with a description of his computer projects without intending to create an unsupportable aura of business substance.

4. *Totality of Impression.* Finally, the overall impression conveyed by the entire selling memo (1368-1372) must be considered. It is two pages of text describing Faggen's business, mostly computer capabilities, a page of earnings summaries and a page listing growth of new clients. Reading this exhibit's four pages as a whole, an overall deceptive "spin" by the series of things left out is unmistakable. Everything said in the memorandum from earnings, to viability derived from long term clients and employees, to computers, is less than complete and accurate and etches out an overall portrait that is misleading. The business described had little relationship to the business sold, and the series of omissions (though each is material in itself) makes Exhibit 3 into one huge deception. The ten year projection forward in Ex. 8 (p. 19, *supra*) shows the expectations Faggen intended to create by the picture he drew. And the proof of such overall deception is in the way the business came apart after the acquisition, with the "adjusted" earnings never reached, a series of rapidly declining years, proving the illusory quality of the "adjustments" to any accountant, more lost clients, and a complete failure to develop a viable computer program after years of losses which were strangling the small actuarial business initially sold (1389, 579, 1406-1407). These business realities directly tied to the deceit in the memorandum, and

Faggen's and Robinson's coordinated fight to keep the facts from coming out, are what brought Titan to court in this case.

5. *Robinson's Role.* The Board and negotiator Kaufman knew Robinson and Faggen were friends, and knew they both sat as consultants on some of the same pension and welfare programs. Frank knew Robinson's firm had handled Faggen's minor office lease at Broadway and 14th Street (289). That is all that was disclosed about their relationship. In fact, Faggen considered Robinson his lawyer. Robinson's firm was handling two serious litigations involving Faggen in 1968, and Faggen paid several thousand dollars for services rendered (359, 419, 1410, 1414). Faggen's own counsel on the Titan transaction, Simon Sheib, was recommended to him by Robinson (420). Robinson handled Faggen's estate and his marital separation negotiations in 1969 and 1970 and became escrow holder for $1.5 million of the Titan Notes for the benefit of Faggen and Faggen's former wife (50). Robinson invited Faggen to join him and his law partners in 1967, 1968 and thereafter in seven real estate investments; they were all limited partners in these private syndicates involving substantial investments (94-95, 440, 359).

Faggen had referred some $40,000 in annual retainers to Robinson in May 1968 by recommending him as counsel to the furniture workers' union and pension plans (356-358a, 97-101a). The retainers (amounting to $250,-000 since 1968) officially started September 1, 1968, a few days before the first negotiation between Kaufman and Faggen held in Robinson's offices (606-608). The furniture workers' pension funds of some $18 million were also transferred from another bank to Chase Manhattan Bank in August 1968, at Faggen and Robinson's recommendation (610-612, 517), impliedly in return for future favors from this patronage. The contact point at Chase for this lucrative fund to manage was Robinson's friend, and co-director at Titan, witness Leonard Casey. Thus Faggen softened up Robinson as the acquisition negotiations ripened through the fall of 1968. A reasonable man could

conclude that Faggen had Robinson "in his pocket" when this deal started. Was only a canon of Robinson's ethics involved here, as held below (35a), or was there also a canon of disclosure at stake, for which Faggen too is responsible under Rule 10b-5? "When the other party to the securities transaction controls the judgment of . . . board members . . . the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board . . . the corporation's choice of action is not made as a reasonable man would make it if possessed of all the material information known to the other party . . ." *Shell* v. *Hensley*, 430 F.2d 819, 827 (5th Cir. 1970).

"It was Ben Robinson's deal," (accountant Russo, 456), but that didn't mean the other executives were ready to give away $5.5 million dollars for nothing. It is now clear they had too much confidence in Faggen's unaudited adjustments, and Robinson's imprimatur on him was neither sophisticated nor disinterested. Faggen's mastery at accounting put him way ahead of Robinson when numbers were put down in the selling memo or projections for ten years in Ex. 8; Robinson, essentially a pension plan specialist, has conceded his lack of securities law and acquisition experience (345-346, 352-353). Mechanical handling of the deal by a young lawyer occurred, because the senior partner was paying back favors to a friend and client. As Robinson's co-participant in the favors being returned, Faggen was like a "tippee" with the same duty of disclosure as Robinson. As in *Affiliated Ute, supra*, at p. 153, where "the sellers had the right to know that the defendants were in a position to gain financially from their sales," Titan was entitled to know from Faggen (and Robinson) that current favors were being repaid in this transaction, and that the ongoing relationship was deep enough to be pernicious. See *S.E.C.* v. *Sitomer*, Lit. Rel. #6107, CCH at ¶94,184 (S.D.N.Y. 1973) where it was held misleading to offer securities in a prospectus without disclosing that the lawyers' independent judgment had potentially been compromised by their contingent and unusual

compensation arrangements based on a successful offering. See proposed Guide 60 (real estate ventures, CCH Fed. Sec.L.Rep. Par. 3820) requiring, *inter alia,* disclosures if an affiliation creates "conflicts in performance of the underwriter's *due diligence* obligations," or if "the same counsel will represent both the partnership" and its manager after closing. In short, Faggen knew he had a potentially improper hold on Robinson's judgment which could be used advantageously, and it was Faggen's duty as seller of securities to disclose it fully. *Shell* v. *Hensley, supra.*

B. There Was No Need to Prove Reliance in a Rule 10b-5 Case Based Upon Omissions to Disclose.

The Court below held that "reliance or lack thereof is the key to this case," and the essence of its decision is that the law required plaintiff "to show that he relied on past misrepresentations and that a reasonable investor would have relied," and in the Court's view, plaintiff did not prove reliance on the contents of the selling memorandum (31a). This was an incorrect rule of law to apply to the facts herein, which are claims of material omissions to disclose the whole truth about Faggen's business. The controlling rule of law is that if the omissions were material, no proof of reliance is required. The Supreme Court in *Affiliated Ute Citizens, etc.* v. *U.S., supra,* at pp. 153-154, enunciated this rule in a face-to-face transaction in securities: "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision . . . This obligation to disclose and this withholding of a material fact established the requisite element of causation in fact." The most recent application of the *Affiliated Ute* principle in this circuit is *Shapiro* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc., supra,* where it was held that the Supreme Court's rule applies not only to face-to-face private transactions in securities, but also to open market purchases where an issuer and underwriter did not an-

nounce publicly revised earnings information in their possession. When the Court below dictated its findings herein on March 19, 1974 onto the record, resting its entire decision on the reliance point, plaintiff's counsel promptly urged that *Affiliated Ute* did not require proof of reliance. But the District Court rejected such argument, saying *Affiliated Ute* involved different facts from the securities purchase in the instant case, implying that Titan and Faggen dealt face-to-face and *Ute* was not such a transaction (31a, 1180). *Shapiro* had not yet been decided, and it is a complete answer to this assumed distinction, for *Shapiro* says that in all cases where material omissions are the gravamen of the claim, whether face-to-face or open market transactions, proof of reliance is no longer necessary. It also makes clear that *Ute* was just like the instant case, a face-to-face securities transaction, saying:

> "Defendants argue that the *Affiliated Ute* rule of causation in fact should be confined to the facts of that case which involved face-to-face transactions. We disagree. That rule is dependent not upon the character of the transaction—face-to-face versus national securities exchange—but rather upon whether the defendant is obligated to disclose the inside information. Here, . . . defendants were under a duty to the investing public, including plaintiffs, not to trade in or to recommend trading in Douglas stock without publicly disclosing the revised earnings information which was in their possession. They breached that duty. Causation in fact therefore has been established." (CCH Fed.Sec.L.Rep. at p. 95,661).

Here, Faggen was under a duty to disclose material adverse facts about the several areas of his business Frank and Kaufman were emphasizing in their request for a memorandum for the board—earnings, clients, and computer skills. Faggen knew that his four years of represented earnings were based on half-disclosed adjustment techniques, that he had recently lost important clients, and that his computer capabilities were rudimentary, and he had a duty to disclose the specifics in these areas. He breached

that duty to Titan as seller of its securities (and purchaser of his stock), establishing causation in fact. *Affiliated Ute* says: "The defendants may not stand mute while they facilitate the . . ." transactions they had "developed and encouraged and with which they were fully familiar. The sellers had the right to know . . ." (406 U.S. at p. 153).

The Court below went off on older reliance cases such as *List* v. *Fashion Park, Inc.*, 340 F. 2d 457 (2d Cir. 1965) holding that legal causation, i.e., reliance, is a necessary element in a Rule 10b-5 case as in any tort case. But in this field the law has changed rapidly in nine years. Judge Timbers says in *Shapiro, supra,* (CCH at p. 95,663): "It is true that prior to the Supreme Court decision in *Affiliated Ute* the so-called connection requirement was stated in terms of causation and reliance," noting the *List* decision. But in omission to disclose cases, the rule has been changed. "As must be apparent from our discussion above, we believe that the Supreme Court's decision in *Affiliated Ute*—which we regard as controlling on the issue of causation in the instant case—is a logical sequel to our prior decisions in such cases as *List* . . . Moreover, *Affiliated Ute* specifically applied to a Rule 10b-5 damage action the causation in fact standard enunciated . . . in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970), where . . . the Court approved dispensing with any requirement of proof of reliance as a prerequisite to recovery in a private damage action."

Thus the foundation of the decision below is an incorrect application of the present law on reliance, and that in itself requires reversal.

C. But Reliance, In Any Event, Was Established.

The opinion below says "I believe the real reliance was . . . most importantly, the fact that the Faggen group seemed to have a good going business . . . and that it had a very strong net worth," and "Titan was in a cash position of a very tight nature and here was an acquisition which would pick up between 2 and 2.3 million cash" (32a, 16a).

This net worth keystone in the Court's conclusion was incorrect. The amount was in fact $1 to $1.3 million. The Court conceded such factual error, right after rendering decision (1178-1179, 51a), correcting the transcript on this amount (and other factual items) weeks after the decision was rendered.[1] But the legal conclusion which rested on the defective keystone remained. It was an illogical conclusion initially to say Titan's executives would pay $5.5 million for only $2.3 million, and disregard earnings.

But with corrected facts in the equation, Titan has been held obliged to pay $5.5 million to get $1 million—5 dollars for 1 (a 500% premium or "interest" rate). The result is so commercially unreal, it cannot stand. Who would throw away 5.5 million dollars to get one million—unless of course the future earning power (demonstrated by prior earnings history) were there to support the price being paid? And once the earnings are back in the equation, the glowing pro-forma presentation of high earnings has to be a reliance document. Moreover, the assumed cash "bind" of Titan in late 1968 was simply not correct; cash was not tight, because of recent sale of the shopping center division (323, 1380), and most of the Faggen securities portfolio was still not liquidated even seven months after the October negotiations, negating any desperate cash need (791, 1464-1465, 261-263A #73-1345). But assuming arguendo, that Titan was buying the Faggen Companies for cash flow, with only $1 million to start with, the cash flow had to come from future earnings, making the earnings statement material. The earnings and ten times multiple is in all discussions with Faggen in Kaufman's recorded notations (1377-1378), and Faggen even tried to obtain $5,750,-000 in Notes for his $571,000 earnings at one point, multiplying his "adjusted" earnings by ten, almost to the penny (1484). The other two reasons below for "no reliance" are (2) that Robinson's good words for Faggen

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[1] Over plaintiff's objection to rewriting the transcript with "corrected pages." These corrected pages in the Appendix follow the original decision as dictated.

convinced the board, and (3) the new management group was hell-bent on making acquisitions (33a). Does a Chairman's willingness to express good words for Faggen (now suspect because of favors owed) mean the board didn't care if the earnings or customers were really there? Or that the zeal for acquisitions meant they would be made at any price, and earnings were irrelevant? These reasons are as untenable as the main ground below for finding no reliance. But rejecting the District Court's legal reasoning, with due respect, on the corrected facts need not be limited to logical analysis—because other facts carry the day on reliance. Six, out of the seven directors who voted, recalled the earnings discussion at the board meeting (or thereafter) unanimously approving the transaction on October 9, 1968, as follows:

1. *Former Chairman Robinson:* "Q. Now, do you further recall . . . the earnings . . . were talked about, at the board meeting? A. . . . They were not in the minutes as I recall, and I have a recollection of the discussions of over a half million dollars earnings. Q. Pretax. A. Pretax. Q. And this was discussed by the various members . . . A. I don't know to what extent and by whom, but I remember the figure . . . it seems to me it came up (332). Q. Did you raise any question with respect to the earnings shown in that memo [$571,262 for 1968 in Ex. 3]? A. No . . . Q. In fact, did you not rely on those figures? A. Rely on it for what? Q. For purposes of the acquisition . . .? A. I assumed those figures were accurate" (343-344). ". . . The board's decision was to approve the recommendation of the president, which I joined;" (347-348). Robinson reaffirmed saying earlier, "I assumed the figures were accurate . Q. You relied on them, didn't you? A. I relied on them plus the examination by our treasurer" (367).

2. *Former Director Leonard Casey:* "It was presented to us on the basis that initially . . . we could acquire the company, get a yield of about ten percent on the acquisition price or somewhere in the neighborhood of 550 thousand dollars . . . Q. When you used the word 'ten per-

cent yield on your investment,' could you explain . . . A. Well, I think they were talking about buying this company for ten times earnings . . . Q. Was any of the information in it [Ex. 3] stated to you orally at the meeting . . .? A. I believe some of it was presented by Mr. Frank at the time . . . I preferred to stay in the real estate business, but, on the recommendation of management, I voted for the acquisition" (516-517). "Q. . . . any discussion about any liquid assets which would come into possession of Titan as a result of this acquisition? A. No, I don't recall that, sir" (520). Does this indicate a desperate need for cash, erroneously assumed by the District Court?

3. *Former Director Alfred Frager:* "Q. What did Mr. Frank say at the board meeting . . . A. . . . He had a sheet of paper in front of him in which he quoted the results of operation . . . here was an opportunity to acquire a company, and actuarial and computer activity that billed for its service, in the area of $1,100,000, the result of which was a net profit before taxes in excess of 50% of those billings in the neighborhood of $550,000 . . . and for the figures of the preceding three years, that the figures average somewhere in the area of just a little below a half a million dollars a year . . . In addition to which the corporation had total assets in the area of $1.5 million, of which marketable securities totalled somewhere around $1 million . . . I remember the comment that any activity that could do gross billings in an area of $1.1 million and come up with such a generous pretax profit of $550,000, in that area, that I would like very much to have a piece of that. It was a splendid result" (390-391).

4. *Former Director-Treasurer McIntyre:* President Anthony Frank "asked me to check out, you know, what the adjustments were and see how they came up with the 571[000]. Q. Did you get anything in writing with respect to those adjustments? A. No. Q. How did you check them out? A. I talked to Harold about it. Q. Did you do anything else other than talk to Harold? A. Not that I remember. Q. Russo [sub-accountant] didn't do any-

thing on that subject, did he? A. Not to my knowledge. Q. Did you accept what Harold told you? A. Yes . . . Q. And did you take his word on the other items, too. A. Yes . . . Q. You took him to be an honest and truthful man, didn't you? A. Yes . . . I knew that they were talking about earnings in excess of $550,000 in the general area. Q. Right. And *you knew that is what Titan was looking for in the deal; is that right?* A. That's right . . ." (1468-1471, emph. supplied).

5. *Former Director Kurt Grunebaum:* ". . . it is quite a number of years . . . if my memory is correct, no written statement was handed out but a presentation was made by . . . Frank, and he . . . mentioned that if Titan . . . would have owned at that particular time the Faggen Corporation, the earnings would be in the neighborhood, I think, between 450 and 500 thousand dollars" (588). Cross-examination: "Q. With respect to your particular attitudes towards this acquisition at that time, was the liquid asset position of the Faggen Companies of importance to Titan at that point? A. Yes, it was of importance, *but it was one of the various factors* which . . . Q. Which entered in your judgment? A. Yes." (589, emph. supplied). Is that supposed to establish a dire cash position as the sole motive of this transaction?

6. *Former President-Director Frank:* "I said they [earnings] were above $550,000 and that they seemed to be growing at a pretty constant clip . . . And did those Board minutes [Frank participated in writing them] make any reference to any of the material you had talked about at the meeting? A. Well, as I reviewed the minutes and the exhibits here, several of the phrases in the minutes parallel the phrasing used in Exhibit 3" (284-285, 191-192A #73-1345).

7. *Former Director, Senior Vice President Eugene Hegy*: He missed the October 9, 1968 board meeting, "but when I got back, both Dick McIntyre and Ben Robinson filled me in . . . They showed me the details, the memorandum [Ex. 3] which had been prepared, and discussed the

deal generally . . . Q. Did you read the financial portion? . . . A. . . . yes, I did." (378). ". . . and I was given an opportunity to pass on the deal, as I say, like any board member. And I did, of course, approve it . . . Yes, I was given a quick rundown of the deal" (381).

8. *Former Negatiator-Lawyer Edmund Kaufman:* (not at meeting, and not a director until December, 1968 when he and Faggen both went on board): "Q. Can you identify Exhibit 3? A. Yes. That looks to me like the submission to the board of directors . . . Q. . . . Did you have familiarity in October of 1968 with the adjusted earnings figures shown on that document? A. Yes. I had quite a bit of familiarity with the adjusted earnings figure shown for the year 1968 and some rather generalized knowledge of the area of the earnings for the prior years . . . from Mr. Faggen" (143-144). ". . . And [as to the adjustments] I assumed I was dealing with a truthful man, and that he was telling me things which on their surface appeared credible" (268-269).

None of these eight individuals have worked for Titan in any capacity for years and (1) Robinson and (2) Casey were presumptively aligned with Faggen at trial (because of conflict-of-interest accusations involving them) as was (4) McIntyre who was Faggen's own witness in the summary judgment motion. The Court below recalled only (3) Frager's testimony on earnings, saying "he wasn't particularly explicit (1149), but as quoted above, he could not have been more explicit—see 390-392,[1] and the other seven were just as plain spoken. Robinson and (6) Frank also saw Faggen's 10-year projection (p. 19, *supra*) showing $570,000 in operating income as a starting base. In sum, what more evidence of earnings significant to the approval could the law require, than the recollection of virtually all the directors at the meeting and all the negotiators?

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[1] The District Court had no complete transcript when it dictated findings right after summations; the trial was also disjointed, with ten partial days of hearings in February and March because of other matters pressing the Court.

Republic Technology, Inc., supra, at p. 550 says "Where a merger is in prospect . . . the most current earnings are of the highest importance . . . Accordingly, failure to convey these earnings accurately, if the discrepancy is at all substantial, *has to be material* to the person being misled" (emph. supp). This is another way of saying on the reliance issue that facts of fundamental materiality like overall earnings imply reliance because of their importance, also saying (at p. 551) "The materiality test is concerned only with whether a prototype reasonable investor would have relied." citing *Chris-Craft Industries* v. *Piper Aircraft, supra.* "The law will presume that plaintiff would have wanted to know the information if he had an inkling of its existence." *Stier* v. *Smith, supra.* If earnings were submitted and discussed, as they were beyond any factual doubt to eight key people, the objective significance of earnings to any acquisition imports reliance as a matter of law. The decision below cannot stand because reliance did not even have to be proven—if plaintiff is right on materiality of the omissions, *Affiliated Ute, supra,* alone requires reversal and judgment for plaintiff. But reliance was proven in any event, and also supports such reversal.

The judgment should be reversed and remanded for determination of Titan's damages from the deceptive acquisition, and payment to Faggen of fair cash value thereof, less credits and set-offs.

POINT II

Apart From The Issue of Liability, Damages Awarded Were Excessive.

A. Judgment For The $5.5 Million Face Amount Of The Ten-Year Convertible 4% Securities, Conceded To Be Worth Only $3.2 Million On Issuance, Amounted To An Illegal Penalty.

If the Court should uphold the findings and conclusions of law on liability, the judgment of damages of $6.45 million

is nevertheless excessive. The District Court dismissed Titan's claim, and said "there is no other defense to the notes"; therefore judgment on the counterclaim accelerating payment thereon is granted (43a). To summarize our argument, the judgment for the face amount (which included *unearned* interest and return on investment) of these low-grade notes years before principal is due, amounts to a penalty, violates the non-waiver provisions of the securities laws and wrongly foreclosed a hearing on proper set-offs against the amount claimed.

Faggen, himself recognizing the commercial reality of the situation urged through his own expert witness (Shinagel) and a written exhibit (1724-1730) that Titan's 4% convertible subordinated installment notes due in ten years were not worth their face amount of $5.5 million on December 2, 1968 when received—but were worth "at most" only $3.2 million on issuance in December, 1968. These 10-year corporate securities, paying only 4% per annum (when high grade debt yields over 12% today), subordinated to senior debt owed to banks and other lenders, could not grow into $5.5 million in just three years without, in effect, enforcing a concealed interest penalty against Titan of $2.3 million. The Court below disagreed on a single ground; "it cannot be said, however, that at the time of sale, Faggen's business was not in fact worth $5,500,000 to Titan. Given this fact, it would not be proper for this Court to say that the $5,500,000 in notes received by Faggen represented a concealed interest rate of $2,300,000" (64a).

What basis is there for saying a seller willing to take only $3.2 million was really selling a commodity worth $5.5 million cash? How can a tribunal assume that what is worth $3.2 million to a seller is in fact worth $5.5 million to a buyer?—particularly after concluding earnings were "somewhat" overstated. There is not a shred of evidence to support this legal conclusion giving a $2.3 million damage windfall. The excess net worth in the Faggen Companies was $1 to $1.3 million; did that make the cash worth five times that, $5.5 million, in the prosperous year

1968 when money was easy to come by for corporations?[1] Commercial common sense does not support such reasoning, and the best test of value is what a seller said he wanted for his pool of assets—subordinated, convertible securities of Titan with a value of $3.2 million in cash equivalent. The zone between what a seller received and what a buyer got for his money cannot be assumed to be a gulf over $2 million wide.

Titan gave a bloc of relatively "low grade" corporate securities as the form of payment under its contracts with Harold Faggen. The Notes, as between Titan and Faggen, did not have a life of their own and were merely an executory promise of future performance of the overall contract at a low interest rate, in a subordinated form, with ten years ahead for their pay-out, and with an equity feature whose potential for capital gain from a market rise in Titan stock was in 1968 their principal attractiveness to Faggen. Faggen was not a bona fide purchaser or holder in due course of a convertible note bought in the bond markets—he was merely the owner of a bargained-for installment covenant, with a conversion right, subject to all the prior dealings and equities that gave rise to the obligations. The securities received by Faggen in this transaction were a substitute for his demand for 500,000 shares of Titan common stock in the initial negotiations (111) and were much closer to an equity security in their fundamental nature and in the minds of both parties, than they were a debt security.[2] Calling a promise to pay a "note" and putting it in an exhibit to the contract on separate pages does not make it one, as between the original parties.

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[1] This holding may be a continuation of the error in first finding $2.3 million in excess net worth, still haunting the conclusions of law below.

[2] The fact that no principal was to be paid until 1974 gave it the "tax free" quality (similar to a stock-for-stock reorganization) Faggen desired until cash payments in bulk were received, and the 4% interest was the minimal return necessary to avoid a higher imputed interest rate under the Internal Revenue Code; the true return on investment was added into principal to insure capital gains.

Even under the New York U.C.C., Art. 8, sec. 102(a)(b) (62½ McKinney's Con. Laws), these "Notes" were investment securities, not commercial paper. It is clear that Faggen did not loan $5.5 million in cash to Titan; he traded the assets of his business for specialized securities. In evaluating his rights (different from a bona fide open market purchaser) under these Subordinated Convertible Notes, the normal protective provisions between true creditors and true debtors, such as the acceleration provision herein, must be tempered by the financial realities of the instant bargain. This was not normal indebtedness for borrowed money; it was qualified indebtedness for bartered assets.

1. *Unearned Return on Investment.* The essence of these Notes is that $3.2 million in 1968 present value became $5.5 million in 1978 future value by capitalizing a fair return on investment each year for ten years, and adding $2.3 million into principal payable in the future. As Faggen's own expert Frederick Shinagel testified, through his memo in evidence of March 5, 1974 (1729-1730):

> "If, for example, the 4% interest rate of the Notes were the appropriate one, then the present value of the Notes would be equal to their future or face value. That would mean the interest payments from the Notes fully compensate for the cost of money, inflation, risk, marketability, etc. Such is not the case . . . Considering . . . the substantially leveraged capital structure with 75% debt, the absence of collateral security for the Notes and their subordination to any future institutional or bank debt that may be created, it would appear that an interest rate of 11% would be appropriate here. Since the Notes already pay 4% interest, the present value derivation should be calculated using a rate of 7% (i.e., 11% minus 4%) . . . =$3.215,000. . . . Overall, value on December 2, 1968 was, at most, $3,200,000."

But time had to pass for this built-in return on investment at 7% per annum to accrue and grow to $5.5 mil-

lion by 1978. To pay the extra $2.3 million of principal as of 1972, seven years before the term of the Notes has elapsed, is to pay unearned interest which has been capitalized to reach $5.5 million. This amounts to a penalty for default rather than fair compensation for breach of contract. An acceleration clause in notes was declared an unenforceable penalty in just these circumstances in *Northtown Theatre Corp.* v. *J. J. Mickelson,* 226 F. 2d 212, 214 (8th Cir. 1955), because "the acceleration clauses in the circumstances disclosed by the record created a penalty and hence were unenforceable and that having invoked the acceleration clause as the basis for its claim to unearned interest it was not entitled to recover." With precise application to Faggen's position the same case below, *In Re Mill City Plastics,* 129 F. Supp. 86, 90 (D.Minn. 1955), says: "if petitioner were allowed the full amount of its claim it could reinvest and be substantially better off than if the bankrupt had fulfilled its contract according to its terms." The Court below itself accepted this principle that capitalized interest cannot be awarded before it is earned, saying an acceleration clause should be unenforceable when it would result in the payment of unearned interest, citing *A-Z Servicenter, Inc.* v. *Segall,* 334 Mass. 672, 138 N.E.2d 266 (1956) and 5 Corbin, *Contracts,* Sec. 1065. We submit that a $2.3 premium for holding convertible notes for their ten year term is equivalent to capitalizing unearned interest—it is a fair return on investment built into the face amount of the Notes whether it is called unearned interest or principal amount. These Notes (really convertible debentures) were first sold to Faggen at 60 ($3.2 million value is 60% of $5.5 million face and is a fair test of value of the assets conveyed as well) and had to be held 10 years to repay par value of 100. Faggen's return on investment was not intended to be paid on "breach date" May 1, 1972, a mere three and a half years after the deal started. The result here gives him a windfall to reinvest at high interest rates,[1] and

[1] Obligations comparable in grade to these 4% subordinated notes could yield huge returns in current tight money markets, where 30 day bank deposits pay 12%.

by maturity date of the first $5.5 million, he will have $8-10 million cash on hand—damages for breach of contract have yielded him more than performance ever would.

Any provision of a contract—whether it is called a liquidated damages provision explicitly or whether it is an acceleration provision which results in additional damages, must be evaluated realistically to determine if it operates as a penalty. *Davy* v. *Crawford,* 147 F. 2d 574 (D.C. Cir. 1945). See *Priebe & Sons* v. *U.S.,* 332 U.S. 407, 413, 418 (1947), "The essence of the law's remedy for breach of contract is that he who has suffered from a breach should be duly compensated for the loss incurred by nonperformance. But one man's default should not lead to another man's unjust enrichment." See *Seidlitz* v. *Auerbach,* 230 N.Y. 167, 174 (1920, Andrews, J.) "The parties must not lose sight of the principle of compensation," or *City of New York* v. *Brooklyn & Manhattan Ferry Co.,* 238 N.Y. 52 (1924), "The tendency of the courts in doubtful cases is to favor the construction which makes the sum payable for breach of contract a penalty rather than liquidated damages." A decent respect for the rights of all participants in a public corporation—senior creditors and shareholders—mandates such view herein, particularly with the strong public policy against assessing any penalty damages against corporations. See *Green* v. *Wolf Corp.,* 406 F.2d 291, 303 (2d Cir., 1968). Turning a seven year $5.5 million debt into a current liability, with its attendant diminution of future credit, and jeopardy of existing credit relationships, is not a punishment to be lightly imposed. This acceleration clause as held in parallel cases, exacts "a penalty with a vengeance." *Minn. Billiard Co.* v. *Schwab,* 190 N.W. 836, 838 (Wis., 1922).

The Court below further reasoned that "the default by Titan on the interest payments here was deliberate[1] and not the result of technical oversight. Titan could have chosen to pay the interest into the court for the duration of this suit but it did not do so." As a result of Titan's

[1] Use of the word "deliberate" suggests retribution analysis, rather than just compensation.

refusal, "Faggen experienced financial restraints and difficulties . . . to his detriment", and this fact is relevant "to a determination of whether the acceleration clause is an unenforceable penalty" (63a). This reasoning cannot withstand analysis, because its first premise that Titan could avoid a default by paying the interest into court is simply not valid. The contract required paying $220,000 annual interest to Faggen, and if paid into court, Titan would have been just as much in default on the $110,000 installment it refused to pay on May 1, 1972 as it is now. Faggen would still have wanted the money himself; and how would money paid into court solve Faggen's assumed financial difficulties? Only an extraordinary proceeding in equity, with a finding (believed legally impossible to obtain) that Titan was performing the contract being attacked merely by paying into court, could validate such alternative. This was not a dispute in equity between stakeholders where the Court could take broad pendente lite steps. It was a counterclaim at law to enforce the rigid requirements of an acceleration clause in a time payment contract; Faggen never asked for payment into court, preferring to accelerate. Moreover, the acceleration (operative in 15 days) was invoked as of May 1, 1972 and any payments into court or even directly to Faggen after that could not cure the first claimed $110,000 default under the technical terms of the Notes. This *post hoc* approach below required writing a new contract between the parties. Courts cannot make contracts; they can only enforce them as written, or enjoin their enforcement.

The second link in the reasoning below, that Faggen's "financial restraints" (63a) during suit are relevant to analysis of whether a contract effects a penalty, is equally invalid. It was no balm to tell Titan to pay the required amounts to Faggen directly where it was shown that the hard value of assets received was far less than the total of $1 million in interest and salary payments previously made to the Faggens, $2.5 million in claims by new holders of the notes, and $1 million in set-offs against Faggen for diverting clients to himself, apart from the fraud claim. In effect, Judge Ryan (back in 1973) enjoined enforcement by author-

izing non-performance in any form, after equitable review of Faggen's "restraints and difficulties" and the Court of Appeals affirmed his factual-legal decision that Titan did not have to pay any interest (or principal) before trial. The decision closed the issue and made the normal desire of a promisee to be paid while a contract is in litigation irrelevant to determining now whether the acceleration clause operates as a penalty in this particular contract. Because of the full hearing on the interest issue first brought on by Faggen a month after suit, Titan's even seeking an injunction against requiring interest payments would have been a superfluous motion. In effect, Titan had leave of court, to refrain from paying interest to Faggen during the pendency of this litigation, closing the issue.[1] On the present issue of whether acceleration effects a penalty herein, a single fact looms as controlling —principal has still not come due; the first installment is November 1, 1974 and they run through 1978. It is grossly inequitable to call a court sanctioned refusal to pay $110,000 a "default," which gives rise to enforcement of an acceleration clause yielding a windfall of millions, i.e., a return on investment without staying at risk in the investment. Senior creditors who loaned real money to the corporation, and thousands of public shareholders should not be so disadvantaged.

2. *The Federal Securities Laws Bar Enforcement of the Acceleration Clause Here.* Faggen is not entitled to accelerate the Notes also because of the non-waiver clause of Section 29 (15 U.S.C. 78 (cc)) of the Securities Exchange Act of 1934. To grant acceleration to Faggen is, in effect, to enforce a penalty against Titan for seeking the aid of the federal courts to rescind what was believed to have been a contract induced by a violation of the federal securities laws. To grant acceleration was to enforce a prohibitive sanction against the litigant merely

[1] Titan also had just cause not to pay the $110,000 to Faggen because he owed it much more in damages for diverting clients and mismanagement, discussed *infra.*, and this ground was argued in that hearing.

for seeking his day in court on a securities case honestly brought and vigorously urged. Such result would be, in effect, to require Titan to pay an entrance fee to the federal court of more than $2.3 million merely for refusing to further perform a putatively illegal contract, and seeking to enforce its rights. The combined provisions of Section 29(a) of the 1934 Act which prohibit any "condition, stipulation or provision binding any person to waive compliance with any provision of this title . . . shall be void," and Section 29(b) which prohibits enforcement of a contract violating the title, should be applied to an acceleration covenant which adds so much to a litigant's damage exposure. *Faggen leaves this case with more than he ever had going in.* The penalty effect of the acceleration clause is in substance a prohibited contractual waiver of rights under the securities laws; few litigants would make application to the federal court to complain of a violation of the securities laws, regardless of their good faith beliefs about the case, if they must pay a 70% premium for losing. Section 29(b) of the 1934 Act excuses a litigant from performance of a contract which violates the securities laws, and to penalize a litigant by grossly inflating money damages because he went to court to vindicate his rights, effectively emasculates the investor protection contemplated in the statute. Any indirect interference with a claimant's right to go to Court and prove a case of securities fraud, where the interference comes from the operation of a provision of a contract involved in a securities transaction, is barred by Section 29 of the 1934 Act. For example, see *Special Transportation Services, Inc.* v. *Balto,* 325 F.Supp. 1185, 1187 (Minn., 1971) refusing to enforce any contractual provision (a limit on recoverable damages) which interferes, by indirection, with the statutory remedies of the 1934 Act. By a parity of reasoning, Section 29 voids a contractual remedy clause that grossly inflates plaintiff's damages merely because he stopped paying and went to court. Enforcing an acceleration clause against someone who applied to a federal court for a right to prove his case, and had leave of court as to his refusal to pay interest, is vitiating the federal remedy by

making it too costly a right to even assert. The holder of debt securities still gets his interest and his principal paid, when due, or the present value of the obligation if paid before term, if the plaintiff attacking the transaction for securities fraud is wrong, albeit in good faith. Specific performance with interest or a remedy of fair compensation damages for breach of contract would never be denied. But should technical application of an acceleration clause give the holder of debt securities even more, as against the broad policy of "non-waiver" of these rights, directly or indirectly?

See *Cohen* v. *Tenney Corp.*, 318 F.Supp. 280, mot. for rearg. 284 (S.D.N.Y., 1970) for another factual context where the securities act principle is stated, "Judicial hostility toward waivers generally requires that the right of private suit for alleged violations be scrupulously preserved against unintentional or involuntary relinquishment." The fact that Titan lost on the issue of liability is irrelevant to the preservation of its right to stop performing a contract believed illegal and seek redress, without application of prohibitive penalties. The "in terrorem" effect of an acceleration clause, which by adding $2.3 million in liability prevents resort to litigation, must be overcome by the federal statute which encourages a good faith application to court. Nothing can detract from the fact that Faggen himself urges he received $3.2 million in cash equivalents, and he is now getting $5.5 million without further risk. Any contractual provision whose practical effect is "abandonment of the buyer's right to choose his forum, and potential abandonment of the other rights under the Act, is in violation of the statute's non-waiver provision". *Reader* v. *Hirsch & Co.*, 197 F.Supp. 111 (S.D.N.Y., 1961). See *Rogen* v. *Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir., 1966), where the Court refused to enforce a contractual declaration of non-reliance, and makes our point herein by saying "were we to hold the existence of this provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a)."

B. The Court Below Denied Plaintiff A Hearing On Valid Set-Offs Against Any Damage Award.

Plaintiff has a right of set-off against the claims by defendant Faggen, based upon the defendant keeping key clients of the businesses sold for himself, and his mismanaging and diverting existing clients of the businesses to himself prior to and after the case was commenced. The details of this anticipated proof of set-off are set forth in the prior appeal on interest (563-565 A (#73-1345) and were even discussed in the appellate brief in #73-1345 (pp. 6, 38) all submitted to the District Court before trial herein, at its request, in lieu of pre-trial briefs. They were a legal excuse not to pay interest, vitiating application of the acceleration clause, as well as an overall set-off at ultimate trial. Judge Ryan back in 1973 determined that this $1 million claim of set-off constituted evidentiary matter which could be properly asserted in reduction of any sums recoverable by defendant Faggen, and denied a motion to amend the pleadings as unnecessary. The Court enforced the rule of flexibility in amending pleadings of *Foman* v. *Davis,* 371 U.S. 178 (1962), by treating the set-offs as evidentiary matter. Discovery and depositions on this matter were conducted in the fall of 1973, and a hearing was always contemplated as part of plaintiff's separate proof on damages. At trial Titan reserved the right to recall witnesses for purposes of proving this set-off (853-854), and its proposed findings at the start of trial had contemplated separate trial of the liability issue from the damage issue, in which the Court concurred. When a damage witness was called by Faggen in the liability trial (for another purpose), plaintiff objected and the Court admonished: "You [Mr. Cooper] agreed before we started with Mr. Powers that we would try the liability issue first . . . I will take it on that limited basis. Then maybe when we get to the damage issue we will have relevancy at that time" (967). When the District Court ruled adversely on liability, Titan promptly moved for its contemplated separate damage hearing. Instead of a damage hearing on the actual value of the Faggen Companies after a finding of fraud, it was to be a damage hearing on the enforce-

ment of Faggen's notes; set-offs were relevant in either type of damage hearing, however. Diverting of clients and mismanagement were breaches of contract by Faggen, to be set-off against his claims to interest and principal under the contract. See *Corbin on Contracts*, Sec. 1253, p. 13, and Sec. 1254, p. 20.

The reason given below for refusing such contemplated damage hearing on the set-offs is that Faggen and his wife sued Titan for $100,000 in vacation and severance pay in state court late in 1973, and Titan there pleaded as counterclaims all the claims in this case including diverting of clients. Such state case was not even out of the pleading stage when a damage hearing was requested herein in May, 1974 (Titan had pressed without success, for removal to federal court for consolidation herewith), discovery has not started there and the counterclaims were a common defensive step (i.e., Faggen "owes us more than we owe him") merely protecting the rights of set-off in state court, which will not come to trial for some three years. The federal court was Titan's tribunal of choice since 1972 for diverting of clients defenses and set-offs. The Court below (59a) used this defensive pleading step taken in state court in 1974 to deprive Titan of its set-offs in the federal trial.[1] But these common law set-offs were an integral part of the instant case long before Faggen started his state case, and even here Titan was always urging a federal claim plus a state claim (on diversity grounds) for common law fraud in the inducement, making a related state claim of set-offs part of the overall dispute. In the instant case, where plaintiff has been told by the Court it must make good on $5.5 million in Notes issued to purchase Mr. Faggen's business, it would be grossly inequitable to permit him to divert away a substantial portion of the business being paid for by Titan. This diverting of business, relying on recall of the witnesses already appearing in the federal trial, not only (a) violated the

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[1] Faggen has recently answered in state court pleading *res judicata* on the diverting of clients set-offs, by reason of the judgment herein, to deprive Titan of a day in court in both tribunals.

express restrictive covenants in Faggen's employment agreement which was made a condition to the acquisition contract, but (b) was also violative of the implied covenants of good faith and fair dealing in all contracts. *Pernet* v. *Peabody Engineering Corp.*, 248 N.Y.S. 2d 132, 135 (A.D. 1st, 1964) and *Foley* v. *D'Agostino*, 248 N.Y.S. 2d 121, 130 (A.D. 1st, 1964). Plaintiff's right to a hearing on these matters as part of the damage issue was elementary due process of law, before the District Court rushed to enter a $6.4 million judgment, particularly when a full hearing on attorneys' fees was anticipated anyway. The District Court was so anxious to have done with this case that it even gave Faggen judgment on $2.5 million in Notes concededly not in his possession. It treated him as a "holder" of Notes that two other individuals were already enforcing as "holders" in separate suits as claimants in due course (his first wife and a lender, Franklin National Bank).

C. Recommended Damage Computation.

Contract damages (disregarding set-offs) here do not come anywhere near the $6.45 million awarded by the District Court. The ruling contract damage principle is that Faggen was entitled to the fair market value of the promised performance on the date of breach; "the aim in view is to put the injured party in as good a position as he would have had if performance had been rendered as promised." *Kaufman* v. *Diversified Industries, Inc.*. 460 F.2d 1331 (2d Cir., 1972).[1] In other words, what was the fair market value on May 1, 1972 of Titan's low-yield convertible securities with *no* viable conversion rights any longer in existence (Titan's stock was far below conversion price)? It is an analysis roughly similar to that of Faggen's expert Shinagel, updated from December, 1968 to 1972. Titan made a written offer of proof by expert witnesses to value these subordinated debt securities, at between 40% to 50% of the face amount—between

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[1] Specific performance would be equally fair, but Faggen opted for money damages only.

$2,200,000 and $2,750,000 as of May 1, 1972. In other words the Notes with par of 100, were bought by Faggen from Titan at 60 ($3.2 million in assets) and were now worth 40 to 50 per cent of $100 in face amount, because (a) interest rates in 1972 were much higher, depreciating the value of 4% notes; (b) the Notes were not registered under the Securities Act of 1933, and not saleable to the public; unregistered securities normally sell at 50% or less of market price, see *Kaufman* v. *Diversified Industries, Inc., supra,* at p. 1335; (c) the Notes were subordinated to senior debt, and Titan had a weak balance sheet, and checkered financial history adversely affecting its current security values; (d) there was no market for an offering of either debt or equity securities of Titan to the public, and it could not compete with comparable subordinated convertible securities in the market place, then selling at 40-50% of par; and (e) the one institutional borrower that valued these Notes at arm's length—Franklin National Bank—valued them at below 20% of par for loan purposes —$1 million were required to be pledged in order for Faggen to borrow merely $180,000. Damages are "determined by the loss sustained or gain prevented at the time and place of breach . . ." *Simon* v. *Electrospace Corp.,* 28 N.Y.2d 136, 145 (1971). These $3.2 million in securities plainly did not appreciate in value between 1968 and 1972 —as acknowledged below (972), they could only have gone down in value because of the economic variables listed.[1]

Faggen is now entitled to breach date (1972) value of the Notes, plus legal interest since breach date, less any set-offs for diverting clients and mismanagement proven. Faggen is not entitled to be put in a better position because of breach than he would have been in had the contract been performed, *Blair* v. *U. S., for Use and Benefit,* 150 F.2d 676 (8th Cir., 1945); and "the test of loss, [is] the amount of

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[1] Valuation was not a one-way street however, for if Titan's stock had gone up, the conversion rights could have made the Notes worth substantially more. Faggen had an unlimited upside on these convertible securities, far different from a conventional debt instrument.

money that the commodity would have brought in the open market at the time and place of the claimant's deprivation." *McCormick on Damages,* § 44, p. 165. As between the original parties Faggen and Titan, these low-grade securities are just another commodity received in exchange for assets, no different than May wheat bartered for September wheat. "Fair market value" is the price at which a willing seller and a willing buyer would complete a transaction with respect to these securities. 5 *Corbin on Contracts,* par. 1004, p. 40; *Whittemore* v. *Fitzpatrick,* 127 F.Supp. 710 (Conn., 1954). *Baer* v. *Durham Duplex Razor Co.,* 239 N.Y.S. 473, 476 (A.D. 1st, 1930), states the same principle with respect to breach of a promise to pay installments of money, because "the cash in hand is more desirable than an obligation", and the test is "the present worth of an obligation to pay money due at such . . . certain time". Between the original parties to the trade there is nothing sacrosanct about a subordinated obligation due years hence with a low yield. See Friendly, J. in *Zeller* v. *Bogue Electric,* etc., 476 F.2d 795, 802 (2d Cir., 1973), "If Bogue has outstanding 8% debentures which were selling say at 80, it would be hard to deny that Belco was damaged if Bogue forced it to purchase at 100 such bonds, whether held in Bogue's treasury or an additional issue, even though they were paid at maturity". Similarly, if Titan's 4% Notes would be selling at 40-50, it would be unconscionable to award Faggen 100 for them as of 1972, years before maturity.

Even the $75,520 in attorneys' fees awarded must be reversed pending resolution of the amount of Faggen's recovery. If damages are substantially reduced, indemnification for cost of attorneys' collection efforts are not compensable at the same rate as the $6.4 million judgment for which attorneys' fees were awarded. A whole new attorneys' fee award is required based on any revised damage award. See the same result mandated in *Kaufman* v. *Diversified Industries, Inc., supra,* at p. 1338.

Conclusion

The entire judgment on liability should be reversed, with judgment entered for Titan on its Rule 10b-5 and common law fraud claims, with remand for determination of Titan's damages from the fraud liability established.

If the decision below on liability is upheld, the case should be remanded for a hearing on contract damages to Faggen on his counterclaim, less valid set-offs to be proven. A new determination on attorneys' fees is also then required.

Respectfully submitted,

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August 8, 1974.

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Martin M. Green,
Of Counsel.

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Due and timely service of Two copies of the within BRIEF is hereby admitted this 8th day of AUGUST 1974

for ....
Attorney s for APPELLEE